82-1369

No. 82-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, AMERICAN PAPER INSTITUTE, INC., CENTRAL ILLINOIS LIGHT COMPANY, MIDDLE SOUTH UTILITIES SYSTEM, POTOMAC ELECTRIC POWER COMPANY, PUBLIC SERVICE COMPANY OF INDIANA, INC., SOUTH CAROLINA PUBLIC SERVICE AUTHORITY, NEVADA POWER COMPANY, AND AMERICAN IRON AND STEEL INSTITUTE,

Petitioners,

v.

UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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February 14, 1983

QUESTIONS PRESENTED

Under the Interstate Commerce Act, revenue adequacy is a concept of paramount importance in the area of maximum rail rate regulation. Rail carriers with inadequate revenues are entitled to certain extraordinary rate freedoms and special considerations to which financially-healthy carriers are not.

In the decision below, the Court of Appeals affirmed a decision of the Interstate Commerce Commission ("ICC" or "Commission") establishing revenue adequacy standards under Section 10704(a)(2) of the Act. The ICC decision held that a) the only standard which should be applied in determining carrier revenue adequacy under Section 10704(a)(2) is whether a rail carrier is earning a rate of return on its net investment base equal to the current cost of capital; and that in applying this standard, b) the presence of unused and nonuseful property in the net investment base could be ignored; c) deferred taxes should be included in the net investment base; and d) the cost of the carriers' debt should be calculated not on the basis of their actual historical interest expenses, but on the basis of the interest which would attach if all debt were issued today, at current rates.

This ICC decision reversed earlier Commission decisions which squarely held that the agency could not, consistent with the statutory definition of revenue adequacy, rely solely on the rate of return standard in determining the adequacy of carrier revenue levels. Under this new standard there are no Class I railroads in the United States which are considered revenue adequate by the ICC.

The question presented is whether the Court of Appeals erred in affirming the ICC's new revenue ade-

quacy standard or the ICC's subsidiary rulings concerning the composition of the net investment base and the cost of debt.

PARTIES TO THE PROCEEDINGS BELOW

The parties to the proceeding below were: Western Coal Traffic League; National Industrial Traffic League; Edison Electric Institute; Chemical Manufacturers Association; American Paper Institute, Inc.; American Iron and Steel Institute; Iowa Power & Light Company; Iowa Electric Light and Power Company; Oklahoma Gas & Electric Company; Southwestern Electric Power Company; Central Illinois Light Company; Middle South Utilities System; Arkansas-Missouri Power Company; Arkansas Power & Light Company; Louisiana Power & Light Company; Mississippi Power & Light Company; New Orleans Public Service, Inc.; Potomac Electric Power Company; Public Service Company of Indiana, Inc.; South Carolina Public Service Authority; Carolina Power & Light Company; South Carolina Electric and Gas Company; Virginia Electric and Power Company; Alabama Power Company; Georgia Power Company; Gulf Power Company; Mississippi Power Company; Southern Company Services, Inc.; Nevada Power Company; Bessemer and Lake Erie Railroad Company and Association of American Railroads.

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OPINIONS BELOW

The opinion by the Court of Appeals is reported as *Bessemer and Lake Erie Railroad Company* v. *Interstate Commerce Commission and United States of America*, 691 F.2d 1104 (3rd Cir. 1982) (App. to Cert. Petn. A). In its opinion, the Court of Appeals affirmed a decision issued by the Interstate Commerce Commission and reported as Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981). (App. to Cert. Petn. B).

JURISDICTION

The Court of Appeals' opinion was filed on October 19, 1982. Timely petitions for rehearing were filed. These petitions were denied by the Court of Appeals on November 15, 1982. (App. to Cert. Petn. C). On December 3, 1982, the Court of Appeals issued its certified judgment, in lieu of a formal mandate. (App. to Cert. Petn. D). A petition to recall the mandate was denied on January 25, 1983. (App. to Cert. Petn. D). Jurisdiction of this Court arises under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The Court of Appeals affirmed the Interstate Commerce Commission's construction of Section 10704(a)(2) of Subtitle IV, Title 49, United States Code (hereinafter "Interstate Commerce Act"), 49 U.S.C. § 10704(a)(2). Section 10704(a) provides, in pertinent part:

> (2) The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Commission shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. However, a rate, classification, rule, or practice of a rail carrier may be maintained at a particular level to protect the traffic of another carrier or mode of transportation only if the Commission finds that the rate or classification, or rule or practice related to it, reduces or would reduce the going concern value of the carrier charging the rate. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

(3) The Commission shall conclude a proceeding under paragraph (2) of this subsection within 180 days after the effective date of Staggers Rail Act of 1980 and thereafter as necessary.

(4) On the basis of the standards and procedures under paragraph (2) of this subsection, the Commission shall, within 180 days after the effective date of the Staggers Rail Act of 1980 and on an annual basis thereafter, determine which rail carriers are earning adequate revenues.

STATEMENT OF THE CASE

In 1976, Congress added a provision to the Interstate Commerce Act which required the ICC to hold a hearing and promulgate, by February, 1978, standards and procedures for determining carrier revenue adequacy. Railroad Revitalization and Regulatory Reform Act of 1976 ("*4-R Act*"), Pub. L. No. 94-210, § 205, 90 Stat. 41. This new section of the law, now codified at 49 U.S.C. § 10704(a)(2),[1] established various financial criteria that the ICC should consider in determining whether a rail carrier was revenue adequate.

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[1] What is now § 10704(a)(2) was originally codified at 49 U.S.C. § 15a(4). In 1978, Title 49 of the United States Code was recodified, without substantive change. Pub. L. No. 95-473, 92 Stat. 1337. *See* Chicago & North Western Transp. Co. v. Kalo Brick & Tile Co., 450 U.S. 311 (1981). Under this recodification, § 15a(4) became § 10704(a)(2).

In 1978, after conducting the Congressionally mandated rulemaking proceeding, the ICC issued a comprehensive decision promulgating standards and procedures for determining carrier revenue adequacy. Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels*, 358 I.C.C. 844, *modified* 359 I.C.C. 270 (1978) ("*Ex Parte No. 338*"). Those standards, codified at 49 C.F.R. § 1109.25 (1978), provided for consideration of "all pertinent financial indicators" in determining whether a rail carrier was revenue adequate. *Id.*, § 1109.25(a)(1). The ICC first applied its *Ex Parte No. 338* standards and procedures in Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*, 362 I.C.C. 198 (1979) ("*Ex Parte No. 353*"). In this decision, the ICC found, based upon an evaluation of all relevant financial data, that 13 of the 36 Class I railroads then operating in the United States were revenue adequate. *Id.*, 362 I.C.C. at 256-57.

In both *Ex Parte No. 338* and *Ex Parte No. 353*, the ICC ruled that it would take into consideration the revenue adequacy status of individual rail carriers in determining whether individual rail rates should be syspended or investigated, and whether individual rates were reasonable. *Ex Parte No. 338*, 358 I.C.C. at 854; *Ex Parte No. 353*, 362 I.C.C. at 277-79. The Commission applied these principles in individual rate cases by sanctioning higher rates on traffic carried by "revenue inadequate" carriers. *See, e.g., Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 587 (6th Cir. 1981); *Burlington Northern Inc.* v. *United States*, 661 F.2d 964, 973-74 (D.C. Cir. 1981); *Celanese Chemical Co., Inc.* v. *United States*, 632 F.2d 568, 576 (5th Cir. 1981), *cert. dismissed*, ___ U.S. ___, 102 S.Ct. 27 (1981); *System Fuels, Inc* v. *United States*, 642 F.2d 112, 116 (5th Cir. 1981); *San Antonio, Texas* v. *United States*, 631 F.2d 831, 848-50 (D.C. Cir. 1980).

After *Ex Parte No. 353*, the ICC issued two additional decisions which calculated the railroads' cost of capital for the years 1979 and 1980 (Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 ICC 344 (1979); Ex Parte No. 381 *Adequacy of Railroad Revenue (1980 Determination)*, 364 I.C.C. 311 (1980)). However, it made no subsequent determinations, after *Ex Parte No. 353*, of revenue adequacy on a carrier-by-carrier basis, indicating that it was considering proposing revisions to its standards.

In October, 1980, Congress enacted the Staggers Rail Act of 1980 ("*Staggers Act*"), Pub. L. No. 96-448, 94 Stat. 1895 (1980). During Congressional consideration of this law the railroad industry, displeased with the standards for determining revenue adequacy adopted by the ICC in *Ex Parte No. 338* and applied in *Ex Parte No. 353*, endeavored without success to have the statutory definition of revenue adequacy amended to provide that the sole standard of revenue adequacy would be a rate of return on net investment equal to the current cost of capital.[2] The *Staggers Act* made substantial changes in other sections of the Interstate Commerce Act, but it left the definition of revenue adequacy unchanged and made only one technical correction in Section 10704(a)(2) itself.[3] While Congress did not alter the definition of carrier revenue adequacy, it did codify the ICC's administrative

[2] This had consistently been the carriers' position, and was the position rejected by the ICC in Ex Parte Nos. 338 and 353.

[3] Section 205 of the 4-R Act had specified that the ICC could "revise and maintain" its revenue adequacy standards and procedures. *Id.* The word "revise" was deleted from the text of Section 205 when the law was recodified as Section 10704(a)(2). In the Staggers Act, Congress reinserted language providing that the ICC could "revise as necessary" its revenue adequacy standards. *Id.*, § 205(b)(1), 94 Stat. 1906.

practice of considering the revenue adequacy status of a rail carrier in rate suspension, investigation and reasonableness determinations, and utilized revenue adequacy as a means for determining when carriers should be entitled to certain new rate freedoms.[4] Finally, concerned about the ICC's failure after *Ex Parte No. 353* to make annual revenue adequacy determinations, Congress added Sections 10704(a)(3) and 10704(a)(4) to the Interstate Commerce Act, requiring the ICC to conclude a proceeding under Section 10704(a)(2) "within 180 days after the effective date of the Staggers Rail Act of 1980 . . ." (Section 10704(a)(3)), and to make a determination of which rail carriers were earning adequate revenues within the same 180 day period and each year thereafter. 49 U.S.C. § 10704(a)(4).

The Commission responded to the *Staggers Act* directives by instituting a rulemaking proceeding it denominated Ex Parte No. 393, *Standards For Railroad Revenue Adequacy* ("*Ex Parte No. 393*") (Notice of Proposed Rulemaking, 45 Fed Reg. 80150, Dec. 3, 1980). Comments were filed by a large number of interested parties, and the ICC's final order was served on March 26, 1981. Therein, in a five member decision including one concurring and one dissenting opinion, the ICC reversed its *Ex*

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[4] *See* Staggers Act § 201(a), adding 49 U.S.C. § 10701a(b)(3) (ICC to consider its Section 10704(a)(2) revenue adequacy findings "[i]n determining whether a rate established by a rail carrier is reasonable. . . ."); Staggers Act § 203(a), adding 49 U.S.C. § 10707a(d) (revenue inadequate rail carriers permitted to take designated rate increases which cannot be suspended by the ICC) and adding 49 U.S.C. § 10707a(e) (ICC to consider Section 10704(a)(2) findings in specified complaint and investigation proceedings); Staggers Act § 217, adding 49 U.S.C. § 10705a (revenue inadequate rail carriers permitted to take specified rate surcharges not available to revenue adequate carriers).

Parte Nos. 338 and *353* decisions by holding that it would no longer consider all available financial evidence in determining whether a carrier was revenue adequate. It proposed instead to make revenue adequacy determinations solely on the basis of whether a rail carrier is earning a rate of return on its net investment base equal to the current cost of capital for the railroad industry, as determined by the ICC. *Id.*, 364 I.C.C. 803, 821 (App. to Cert. Petn. B-13-19). In so holding, the ICC also ruled (1) deferred taxes should be included in the net investment base (*id.*, 364 I.C.C. at 814) (App. to Cert. Petn. B-12); (2) unused and nonuseful assets need not be excluded from the net investment base (*id.*, 364 I.C.C. at 811) (App. to Cert. Petn. B-11); and (3) carrier debt costs should be calculated as though all carrier debt were paying current interest rates, rather than on the basis of the amounts actually being paid by the railroads for interest expenses. *Id.*, 364 I.C.C. at 816 (App. to Cert. Petn. B-14). Using this new standard, only three atypical carriers out of thirty-six Class I railroads were found revenue adequate. *Id.*, 364 I.C.C. at 826 (App. to Cert. Petn. B-24). This number has since dwindled to zero under the ICC's most recent revenue adequacy determination. Ex Parte No. 439, *Railroad Revenue Adequacy—1981 Determination* (Decision served Nov. 18, 1982) (unprinted).[5]

Petitions for review of the ICC's *Ex Parte No. 393* decision were filed under 28 U.S.C. §§ 2321 and 2345 by numerous concerned shipper organizations, representing thousands of individual rail shippers. Most of these shippers are utilities or businesses who are dependent upon the railroad industry to ship bulk commodities such as

[5] The Fort Worth and Denver Railroad and the Clinchfield, the only two carriers which were found revenue adequate in Ex Parte No. 439, no longer exist because they have both been merged into larger parent railroads.

coal, iron ore, chemicals, and pulpwood. This bulk traffic is captive to the rail industry, and in recent years railroads have aggressively attempted to raise rates on this traffic in order to promote their "revenue adequacy." The railroad industry also filed a limited challenge to the ICC's order but, as a whole, the industry supported the ICC's order and the industry's chief spokesman, the Association of American Railroads, intervened in support of the Commission.

Before the Court of Appeals, shipper-petitioners filed extensive briefs describing, in detail, how the ICC's *Ex Parte No. 393* order constituted an abrupt, unreasoned and erroneous departure from its previous, and correct, interpretation of Section 10704(a)(2). They also explained that because of the importance of revenue adequacy considerations in the ICC's determination of maximum reasonable rail rates, the truly massive gap between the railroads' existing earnings and those deemed necessary to achieve adequate revenues under the Commission's new standard would effectively deprive captive rail shippers of any maximum reasonable rate protection, as well as frustrate other important goals of the Interstate Commerce Act.

In a decision issued some three weeks after oral argument, the Court of Appeals affirmed the Commission's decision in all respects. It found that the overall policies pursued by the agency were consistent with the directives of the Congress in the relevant statutory provisions. Subsequent petitions for rehearing and rehearing en banc, and for recall of the court's mandate[6] were denied. (App. to Cert. Petn. C, E).

[6] The case was decided by a panel consisting of one circuit court judge and two district court judges. A petition to recall the court's mandate was filed by certain petitioners on the grounds that under a recent amendment to 28 U.S.C. § 46(b) the case should have been

REASONS FOR GRANTING THE WRIT

I.

THIS PETITION RAISES CRITICAL QUESTIONS CONCERNING THE PROPER ADMINISTRATION OF THE RATEMAKING PROVISIONS OF THE INTERSTATE COMMERCE ACT

In the *4-R Act*, Congress completely freed from ICC maximum rate regulation all rates on competitive rail traffic.[7] For "captive" rail traffic, however, Congress recognized the need for continuing government regulation in order to protect shippers against exorbitant prices. This regulatory scheme was maintained in the *Staggers Act*.

The practical effect of the new ICC revenue adequacy standards, affirmed by the court below, will be to deprive captive rail shippers of the maximum rate protections which Congress intended them to have. It does this by relying upon an artificial and unrealistic measure of a railroad's financial health, under which the "shortfall" between existing earnings levels and "adequate" earnings levels is so immense that the Commission cannot

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heard and decided by a panel including at least two circuit court judges. This petition was denied by the court with an opinion explaining that only one judge on the Third Circuit was eligible to hear the case. (App. to Cert. Petn. E.). It would thus appear that the petition for rehearing en banc was decided by a single judge.

[7] This was done through adoption of the "market dominance" jurisdiction standard. 49 U.S.C. § 10709. The purpose of the 4-R Act market dominance standard is to deregulate rail rates in markets where carriers face transportation competition, but leave regulation in place where carriers retain monopolistic pricing power over particular traffic segments. Western Coal Traffic League v. United States, 694 F.2d 378 (5th Cir. 1982); Atchison, T. & S.F. Ry. v. ICC, 580 F.2d 623, 636-37 (D.C. Cir. 1978). By and large, the traffic subject to continuing ICC regulation includes heavy loading commodities such as coal, chemicals and other bulk commodity descriptions for which railroads provide the only feasible mode of transportation.

reconcile the two statutory goals of assisting the carriers to achieve revenue adequacy and maintaining reasonable rate levels on captive traffic.

Under the Interstate Commerce Act, the Commission must take into account the adequacy of a carrier's revenues as determined under Section 10704(a)(2) in determining whether rail rates filed by carriers are reasonable. 49 U.S.C. § 10701a(b)(3). In addition, a carrier's eligibility for certain special procedural protections against challenges to rate increases is determined on the basis of revenue adequacy. 49 U.S.C. § 10707a(d). Thus, the Commission's revenue adequacy determinations made under Section 10704(a)(2) will affect virtually every rail ratemaking decision over which the ICC exercises its regulatory jurisdiction.

Given the broad application of the Commission's Section 10704(a)(2) findings in establishing rail rates, it is of the utmost importance that the standards and procedures that the Commission uses to determine which railroads are or are not revenue adequate, and the sums they need to obtain revenue adequacy, be determined in accordance with the directions given by Congress in Section 10704(a)(2). To the extent that the Commission has erroneously interpreted its Section 10704(a)(2) mandate, the mistake becomes magnified hundreds or thousands of times as the Commission applies its erroneous standard in the ratemaking cases brought before it by concerned shippers.

The linkage between revenue adequacy and maximum ratemaking policy is very strong and direct. For the past several years, the ICC has been endeavoring to formulate rational and consistent standards for determing maximum rail rates for coal transportation, the largest body of captive traffic, in a proceeding known as Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide*. Af-

ter considering the implications of the Commission's new revenue adequacy standards in connection with the development of those ratemaking guidelines, however, the ICC staff concluded that "[a] politically and socially acceptable maximum rate policy cannot accomplish the revenue adequacy measure defined in Ex Parte No. 393."

Although the Commission has been refraining from deciding maximum rail rate cases while it endeavors to complete development of its new ratemaking guidelines, its decisions in the few cases it has been forced to decide under statutory deadlines have established that it views revenue adequacy considerations as preeminent and overriding factors in determining whether rail rates are too high. In a series of cases involving appeals by railroads under 49 U.S.C. § 11501(c) from decisions of state agencies prescribing maximum reasonable rate levels on intrastate traffic, the Commission has rejected the states' determinations on the ground that the states have failed to reflect sufficient consideration of the carriers' revenue needs. Docket No. 38793, *Petition For Review Of A Decision Of The Public Service Commission Of West Virginia*, (Decision served March 18, 1982), appeal docketed No. 82-3122, *Wheeling-Pittsburgh Steel Corporation* v. *ICC, et al.* (3rd Cir.); Docket No. 38809, *Louisville & Nashville—Petition To Review Decision Of Kentucky Railroad Commission*, (Decision served April 15, 1982), appeal docketed No. 82-3312, *Kentucky Utilities Co., et al.* v. *United States, et al.* (6th Cir.); Docket No. 38946, *Petition Of Louisville & Nashville Railroad Co. For Review Of A Decision Of The Public Service Commission Of Indiana*, (Decision served November 24, 1982), appeal docketed No. 82-2399, *Public Service Company of Indiana, Inc.* v. *United States*, (D.C. Cir.).

In one of these cases, Docket No. 38809, *supra*, the Commission described the role of revenue adequacy considerations in ratemaking as follows:

> [T]he unequivocal mandate of Congress in the Staggers Rail Act of 1980 is promotion of revenue adequacy. . . . Thus, revenue adequacy must be a key consideration in every rate reasonableness proceeding.

Id., at sheet 7. On the basis of the Commission's increasing emphasis on revenue adequacy in these recent cases, an ICC administrative law judge has held that "[u]ntil the carriers are revenue adequate as determined by the ICC no rate in this Judge's opinion can be found to be above a maximum reasonable level." Docket No. 37801S, *Aluminum Company of America* v. *Bauxite & Northern Railway Co.*, (Decision served December 21, 1982).

Not only do the ICC's new revenue adequacy standards subvert maximum rate regulation by establishing an unfair and unreasonable goal which rate regulation policy must then attempt to achieve, they deprive the concept of revenue adequacy of any meaning as a standard for differentiating between financially weak and strong carriers. As a result, the Congressional design that revenue adequacy serve as a triggering mechanism for certain extraordinary procedural ratemaking devices[8] has been entirely defeated.

Under the new standards, railroads such as the Southern Railway and the Union Pacific, which are widely regarded in the business and financial communities as financially solid and prosperous companies, are viewed as being far removed from the goal of revenue adequacy. Similarly, a carrier such as the Burlington Northern Railroad, which on the basis of the Commission's new stand-

[8] See fn. 4, *supra*.

ard of revenue adequacy appears to be on its last legs, is described by the financial press as a "cash cow,"[9] able to throw off sufficient cash from its operations to enable its parent to acquire El Paso Natural Gas Company for some $600 million.[10]

Some of the specific errors in the Commission's decision are described, *infra*, but the stark contrast between the results obtained under the new revenue adequacy standard and the real world is reflected in the fact that an ICC staff survey of major railroad financial analysts concluded that "there was a unanimity of views" that "[n]o single ratio should be employed as the sole determinant of revenue adequacy."[11] Indeed, most of the analysts surveyed indicated that they would not even consider return on investment as an indicator of revenue adequacy.[12]

Results such as those obtained under the revenue adequacy standards adopted in *Ex Parte No. 393* are clearly not what Congress envisioned when it enacted Section 10704(a)(2). Congress intended that the ICC administer this law in such a way as to make a meaningful distinction between financially strong and weak railroads, and then to apply these rational findings in carrying out its ratemaking duties under the Interstate Commerce Act. The ICC, with the approval of the Court of Appeals, has devised a standard of carrier revenue adequacy that does not comport in any respect with the Congressional mandate it was created to meet.

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[9] *See Business Week*, March 8, 1982, at 112-113.

[10] *The Journal of Commerce*, February 9, 1982, at 2A.

[11] This memorandum was brought to the attention of the lower court, and included in the administrative record. *See* Motion to Supplement Record Filed by Nevada Power Co. on April 26, 1982 at Appendix A, p. 6.

[12] *Id.*

II.

IMPORTANT QUESTIONS OF FEDERAL LAW APPLICABLE IN ALL PROCEEDINGS UNDER THE INTERSTATE COMMERCE ACT WERE WRONGLY DECIDED BY THE COURT BELOW

A. Section 10704(a)(2) Expressly Precluded The Commission From Relying Upon The Return On Investment Test As The Sole Measure Of Railroad Revenue Adequacy

Prior to its *Ex Parte No. 393* decision, the ICC had never relied upon return on investment data as the sole measure of rail carrier financial health. As stated by the Coordinator of the ICC's massive pre-*4-R Act* study of rate base/rate of return ratemaking in the rail industry, "[r]ate of return on net investment . . . has never been used as a sole criterion of revenue need." Ex Parte No. 271, *Net Investment—Railroad Rate Base and Rate of Return*, 345 I.C.C. 1492, 1565 (1976). The principal and long recognized problem with using a rate base/rate of return standard for railroads is that their rate base is not regulated, and the "used and useful" character of significant portions of this base has been called into serious question. *See, e.g., id.* at 1521. Because of these and other problems, the ICC traditionally supplemented rate of return data with many other "financial data." *Id.*, 345 I.C.C. at 1565.

Congress was fully aware of this situation when it enacted Section 10704(a)(2) in 1976. Under the statute, revenue levels were to be evaluated not only in terms of whether they provided a "reasonable . . . return . . . on capital employed in the business," but also in terms of whether they provided a "flow of net income . . . adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital and cover the effects of inflation." 49 U.S.C. § 10704(a)(2). It was also required that

the Commission determine whether conditions of "honest, economical and efficient management" existed. *Id.*

In the Senate Report accompanying its version of Section 10704(a)(2), the Senate took pains to stress that railroad revenue adequacy could not be evaluated solely by reference to a return on investment standard:

> Previous analysis of the adequacy of regulated industry revenues has focused upon adequate returns on investment. While this type of analysis may need to be continued, *it is equally important* for the Commission to focus on the level of revenue needed to provide and maintain adequate service in the public interest. This requires emphasis upon present and future revenue levels under honest, economical and efficient management *as opposed to a theoretically adequate rate of return on investment* that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest."

S. Rep. No. 94-499, 94th Cong. 2d Sess. 51-52 (1975) (emphasis supplied). The Senate Committee's language could not have been more direct. As one standard among others, return on investment could be reasonably considered. But it could not be "consecrated" as the sole and exclusive criterion of revenue adequacy.

Because Congress did not want the ICC to rely exclusively upon "theoretically adequate rate of return on investment" data, and instead intended that the ICC consider and weigh other financial indicators, it wrote a statute in broad terms requiring the Commission to look to all relevant financial evidence. A Memorandum prepared by the ICC's staff itself in 1980 illustrates in graphic detail the spectrum of financial evidence—in addition to rate of return data—which was called for under the statute's definition of revenue adequacy:

Requirements of Title 49 Section 10704(a)(2) of U.S. Code	Appropriate Financial Ratio
1. Cover total operating expenses, including depreciation and obsolescence.	*Operating Ratio
2. Provide a reasonable and economic profit or return (or both) on capital employed in the business.	*Return on Investment (ROI) *Return on shareholders' equity (ROE) *Return on total capitalization (ROTC)
3. Provide a flow of net income plus depreciation adequate to support prudent capital outlays.	*Percentage of increase in net transportation investment
4. Assure repayment of a reasonable level of debt.	*Throw-off-to debt ratio (TOTD) *Fixed charges coverage ratio (FCC)
5. Permit raising of needed equity capital.	*Return on shareholders' equity
6. Cover effects of inflation.	*Comparison of ROI to cost of capital
7. Attract and retain capital in amounts adequate to provide a sound transportation system.	*ROI, ROE, ROTC and dividend payout ratio

(Memorandum by Acting Chief, Section of Financial Analysis, I.C.C. to Director of Financial Analysis, Dated May, 1980).[13]

Analysis of the text and legislative history of Section 10704(a)(2) demonstrates Congress' intention to preclude the ICC from relying solely upon a rate base/rate of return standard in measuring the adequacy of railroad revenues. Support for this conclusion also comes from *San Antonio, Texas* v. *United States*, 631 F.2d 831, 850 n.104 (D.C. Cir. 1980), in which the D.C. Circuit recog-

[13] See fn. 11, *supra*.

nized that Section 10704(a)(2) "does indicate that the Commission should not focus solely on a rate of return analysis but instead should adopt a prospective view of carrier revenue needs."

In revenue adequacy proceedings prior to *Ex Parte No. 393*, the Commission itself acknowledged that Section 10704(a)(2) prohibited exclusive reliance upon a single measure of revenue adequacy. In its Notice of Proposed Rulemaking in *Ex Parte No. 338*, the Commission stated clearly that—

> Section [10704(a)(2)] does not envision that the rate of return will be the sole factor to be considered in judging carrier revenue adequacy.
>
> * * *
>
> The fact that section [10704(a)(2)] contemplates something in addition to rate of return analysis is confirmed by its legislative history.

Id. 355 I.C.C. at 904. This finding was expressly reaffirmed by the Commission in its *Ex Parte Nos. 338* and *353* decisions. *See*, *Ex Parte No. 338*, 358 I.C.C. at 858-59, 904; 359 I.C.C. at 273; *Ex Parte No. 353*, 362 I.C.C. at 216.

In electing to rely solely upon the return on investment standard in *Ex Parte No. 393*, the Commission's decision did not even *address* the statutory question of whether Section 10704(a)(2) permitted the use of a single standard. Its argument in favor of the return on investment test was based solely upon considerations of "policy." At no point in the *Ex Parte No. 393* decision did the Commission take note of its previous findings that the statute precluded the use of a single standard. At no point did the Commission explain how or why its previous holding that a multiplicity of standards were required by the law had been in error.

Decisions of this Court have made it crystal-clear that when an agency wishes to change its interpretation of a statute, it must explain why its earlier interpretation was incorrect. *Atchison, Topeka & Santa Fe Ry.* v. *Wichita Board of Trade*, 412 U.S. 800, 808 (1978) (*Wichita Board*) (plurality opinion); *Secretary of Agriculture* v. *United States*, 347 U.S. 645, 652-54 (1954). *Accord*, *Central Power & Light Co.* v. *United States*, 634 F.2d 137, 150 (5th Cir. 1980), *cert. den.* 454 U.S. 831 (1981). As explained by the plurality in *Wichita Board*, this principle is a "simple but fundamental rule of administrative law. . ." *Id.* at 807 (quoting *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947)). Under this principle, the Commission's abrupt and unexplained departure from its own statutory findings is clearly reversible error, and should have been so recognized by the Court of Appeals.

Section 10704(a)(2) forbids the reduction of revenue adequacy determinations to any single standard, such as the return on net investment test. This fact is borne out by the terms of the statute itself and its accompanying legislative history—and has been recognized by the U.S. Court of Appeals for the D.C. Circuit as well as by the Commission itself in its prior revenue adequacy proceedings. In *Ex Parte No. 393* the Commission made no explicit finding that the statute authorized its action and in no way identified or explained the error of its prior decisions. While Petitioners pointed this deficiency out to the court below, the court was unmoved and affirmed the Commission's action. These departures from established rules of administrative decisionmaking clearly demand consideration by this Court, and reversal of the Court of Appeals' decision.

B. Contrary To The Statute And Basic Precepts Of Ratemaking Enunciated By This Court, The Court Of Appeals Upheld The ICC's Decision To Include Unused And Nonuseful Assets In The Carriers' Rate Base

Section 10704(a)(2) declares that the ICC is to maintain standards for revenue adequacy that will cover a return on capital "employed in the business" of railroading. This statutory command reflects a basic rule of regulation, long recognized by this Court, that a regulated entity is not entitled to a return on assets "not used and useful" in rendering its services. *See, e.g., Denver Union Stock Yard Co.* v. *United States*, 304 U.S. 470, 475 (1938). This principle was recently summarized by the D.C. Circuit, which, after reviewing the decisions of this Court, concluded that the exclusion of unused and nonuseful assets was an enduring regulatory precedent:

> In *Smyth* v. *Ames* [169 U.S. 466, 546] the Supreme Court articulated the guiding principle that 'the basis of all calculations as to the reasonableness of rates to be charged . . . must be the fair value of the property *being used by it for the convenience of the public.*' Although methods for determining values of rate base items have evolved since *Smyth* v. *Ames*, the precedent endures that an item may be included in a rate base only when it is 'used and useful' in providing service.

Tennessee Gas Pipeline Co. v. *FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979) (emphasis in original) (footnotes omitted) *cert. den.* 445 U.S. 920 and 447 U.S. 922 (1980).

The "used and useful" property issue is of particular importance in the field of railroad rate regulation. Prior to its decision in *Ex Parte No. 393*, the Commission had for over half a century eschewed reliance on the rate of return standard as the sole determinant of the financial health of the rail industry because the railroad rate base is unregulated, and the used and useful character of that

base posed a question the ICC could not answer without conducting a valuation investigation. *See* Ex Parte No. 271, *Net Investment—Railroad Rate Base and Rate of Return*, 345 I.C.C. 1492, 1521 (1976).

In *Ex Parte No. 393*, the ICC recognized that elimination of assets "that are neither used nor useful" was "crucial" to its selection of the rate base/rate of return standard as the sole measure of carrier revenue adequacy. *Id.*, 364 I.C.C. at 811. Nevertheless, the ICC, with the Court of Appeals' approval (681 F.2d at 115), ignored its own logic and accepted a rate base that was not purged of unused or useless assets.[14] Review by this Court is necessary to resolve this glaring error in the ICC's rate base/rate of return standard.

C. The Court Of Appeals Authorized The Commission To Utilize A Cost Of Debt In Its Revenue Adequacy Standard Which Is Flatly In Conflict With The Statutory Scheme

Carriers, like other businesses, issue debt instruments. The cost of this debt to the carriers is the interest and principal payments they must make, with the interest set forth in the debt contract. Section 10704(a)(2) requires the ICC to calculate the amounts carriers need for the "repayment of a reasonable level of debt." Prior to the issuance of the *Ex Parte No. 393* order, the Commission properly held that to meet the debt "repayment" criteria set forth in Section 10704(a)(2), carriers had to earn sufficient sums to meet the interest and principal

[14] The only railroad witness to address the issue concluded, in his limited analysis of only one part of the carriers' rate track structures accounts, that this part included nearly $225,000,000 in unused and nonuseful property. See Joint Appendix filed in the Court of Appeals at page 317.

repayment requirements actually set forth in their debt contracts, the so-called "embedded" level of debt. *Ex Parte No. 353*, 362 I.C.C. at 224; *Ex Parte No. 338*, 358 I.C.C. at 894.

In *Ex Parte No. 393*, the ICC reversed itself by holding that all of the carriers' debt costs would be considered equal to their *current* cost of debt, even though much of this debt was contracted for years ago at lower rates. *Id.*, 364 I.C.C. at 816. Thus, for example, if a carrier issued in 1970 a bond carrying a 6% interest charge, under its decision the ICC would assume for purposes of Section 10704(a)(2) that the carrier would have to earn a return equal to the interest rate on debt issued at the current time. If the current interest rate on debt was 12%, the Commission would consider the 6% bond to be a 12% bond. This methodology drastically misstates carrier debt costs. Indeed, using 1979 data, carriers' debt costs for revenue adequacy purposes (i.e., using current debt costs) would be $201,000,000 greater than their actual cost of debt.[15] The Court of Appeals' conclusion upholding this overstated capital cost should be set aside.

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[15] See Joint Appendix filed in the Court of Appeals at page 672. Where current debt rate is higher than the embedded debt rate, use of the current debt rate rather than the embedded debt rate also distorts the equity requirements established by the Commission and the Congress for revenue adequacy. To the extent that a railroad earns in excess of its embedded debt rate, the excess monies will flow directly through to the equity holder. Thus, the actual rate of return will not be the rate of equity return established by the Commission in its revenue adequacy proceedings, but will be that rate of return *as increased* by the difference between the embedded and current debt return.

III.

THE COURT OF APPEALS' RULING THAT DEFERRED TAX RESERVES MAY BE INCLUDED IN THE RAILROADS' RATE BASE CONFLICTS WITH THE DECISIONS OF THREE OTHER COURTS OF APPEALS ON THE SAME MATTER

In determining the sum of money that should be included in the railroads' net investment base under the rate of return standard which it adopted, the ICC included those amounts carried on their books as reserves for deferred federal income taxes. *Ex Parte No. 393*, 364 I.C.C. at 813-814. Such reserves for deferred taxes are created when accelerated depreciation is used by the railroads for tax purposes, while at the same time railroad ratepayers provide funds as if the straight-line depreciation accounting used for ICC purposes was also being used for federal tax purposes. Unless and until the deferred federal income taxes are paid, the funds provided by the ratepayers and included in the deferred tax reserves are available to the railroads for investment, free from any requirement that they pay interest or dividends. *Cf.*, *FPC* v. *Memphis Light, Gas and Water Division*, 411 U.S. 458, 459-460 (1973).

The ICC, however, with the approval of the Court of Appeals, declined to treat the deferred tax reserves as cost-free capital, either by deducting them from the rate base before applying the adopted rate of return to determine the railroads' revenue adequacy or by applying an adjustment to the required rate of return to reflect the cost-free nature of these capital funds provided by the railroad ratepayers.

This action by the Court of Appeals in approving the ICC's treatment of deferred tax reserves is in conflict with decisions on the same issue by three other courts of appeals. *See*, *Antonio, Texas* v. *United States*, 631 F.2d

831, 847 (D.C. Cir., 1980); *Iowa Public Service Company* v. *I.C.C.*, 643 F.2d 542, 546-547 (8th Cir., 1981); and *Cleveland-Cliffs Iron Co.* v. *I.C.C.*, 664 F.2d 568, 586 (6th Cir., 1980). The Court of Appeals' discussion of this issue not only fails to recognize the contrary decisions in other courts of appeals, but evidences a basic misunderstanding of the issue.

The shipper petitioners before the Court of Appeals argued that when it elects to normalize for federal income taxes, the Commission must make an appropriate adjustment in the rate base or the rate of return to reflect the availability of this cost-free capital. Three United States Courts of Appeals have agreed that there must be an appropriate adjustment to account for the cost-free nature of the funds. For example, in *San Antonio, supra*, 631 F.2d at 847, the District of Columbia Circuit held:

> "As this court has recognized on more than one occasion, the principle of excluding a deferred tax reserve from the rate base, as such reserve comes into existence, is an *essential component* of an agency's election to normalize taxes for ratemaking purposes.[87] Otherwise the rate payer who has paid higher rates reflecting normalization accounting would be paying the carriers for earnings on the tax differential even though it was the rate payer who contributed the differential in the first place.
>
> 87. E.g., *Public Sys.* v. *FERC*, 606 F.2d 973, 975-76 (D.C. Cir. 1979); *Memphis Light Gas & Water Div.* v. *FPC*, 500 F.2d 798, 800 (D.C. Cir. 1974). See Warren, Tax Accounting in Regulated Industries: Limitations On Rate Base Exclusions, 31 Rutgers L. Rev. 187, 189-94 (1978).

The question in the present case is not whether railroads should be permitted to *earn* a return on the funds generated by normalization, which are accounted for as reserves for deferred taxes. Petitioners did not make this

contention in the court below, and do not so argue here. Rather, the question is whether, in determining revenue adequacy, the railroads should be deemed to have incurred capital costs in obtaining these deferred tax funds which are provided by the ratepayers without cost to the railroads. The failure of the Court of Appeals to recognize this distinction further contributed to its erroneous treatment of the deferred tax issue.

Over $3.5 billion was included in the deferred tax accounts of the Nation's Class I railroads in 1979. Using a 1979 cost of capital, the inclusion of this cost-free capital would increase the carriers' annual revenue "requirement" by at least $634 million.[16] The Court of Appeals' decision to allow this addition of $634 million in nonexistent capital costs must be reviewed to resolve the conflict among the courts of appeals on this issue.

[16] See Joint Appendix filed in the Court of Appeals at page 667.

CONCLUSION

For the foregoing reasons, certiorari should be granted and this matter should be set for briefing and oral argument before this Court.

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February 14, 1983

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492

BESSEMER AND
LAKE ERIE RAILROAD COMPANY,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and
UNITED STATES OF AMERICA,
Respondents

ASSOCIATION OF AMERICAN RAILROADS,
WESTERN COAL TRAFFIC LEAGUE,
Intervenors

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE,
Intervenors

No. 81-2633

ALABAMA POWER COMPANY.
GEORGIA POWER COMPANY,
GULF POWER COMPANY,
MISSISSIPPI POWER COMPANY,
SOUTHERN COMPANY SERVICES, INC.,
Petitioners

v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2634

CHEMICAL MANUFACTURERS ASSOCIATION,
Petitioner

v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2635

EDISON ELECTRIC INSTITUTE,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2636

AMERICAN PAPER INSTITUTE, INC.,
Petitioner

v.

UNITED STATES OF AMERICA and
INTERSTATE COMMERCE COMMISSION,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,
Intervenors

No. 81-2637

ASSOCIATION OF AMERICAN RAILROADS,
Petitioner

v.

INTERSTATE COMMERCE COMMISSION and THE UNITED STATES,
Respondents

WESTERN COAL TRAFFIC LEAGUE,
Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE
Intervenors

81-2638

IOWA ELECTRIC LIGHT AND POWER COMPANY, IOWA POWER AND LIGHT COMPANY, OKLAHOMA GAS & ELECTRIC COMPANY, SOUTHWESTERN ELECTRIC POWER COMPANY,

Petitioners,

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA,

Respondents

WESTERN COAL TRAFFIC LEAGUE,

Intervenor

CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY THE NATIONAL INDUSTRIAL TRAFFIC LEAGUE CAROLINA POWER & LIGHT COMPANY SOUTH CAROLINA ELECTRIC AND GAS COMPANY VIRGINIA ELECTRIC AND POWER COMPANY AMERICAN IRON AND STEEL INSTITUTE ASSOCIATION OF AMERICAN RAILROADS,

Intervenors

No. 81-2859

WESTERN COAL TRAFFIC LEAGUE,
Petitioner

v.

UNITED STATES OF AMERICA and
INTERSTATE COMMERCE COMMISSION,
Respondents

CAROLINA POWER & LIGHT COMPANY AMERICAN PAPER INSTITUTE, INC. VIRGINIA ELECTRIC AND POWER COMPANY NATIONAL INDUSTRIAL TRAFFIC LEAGUE SOUTH CAROLINA ELECTRIC & GAS COMPANY ASSOCIATION OF AMERICAN RAILROADS AMERICAN IRON AND STEEL INSTITUTE CENTRAL ILLINOIS LIGHT COMPANY MIDDLE SOUTH UTILITIES SYSTEM ARKANSAS-MISSOURI POWER COMPANY ARKANSAS POWER & LIGHT COMPANY LOUISIANA POWER & LIGHT COMPANY MISSISSIPPI POWER & LIGHT COMPANY NEW ORLEANS PUBLIC SERVICE, INC. POTOMAC ELECTRIC POWER COMPANY PUBLIC SERVICE COMPANY OF INDIANA, INC. SOUTH CAROLINA PUBLIC SERVICE AUTHORITY NEVADA POWER COMPANY,
Intervenors

(ICC Ex Parte No. 393)

ON PETITION FOR REVIEW OF AN ORDER OF THE
INTERSTATE COMMERCE COMMISSION

Argued: September 20, 1982

Before: GIBBONS, *Circuit Judge*, FISHER, *Chief Judge** and MEANOR, *District Judge**

(Opinion Filed: October 19, 1982)

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OPINION OF THE COURT

GIBBONS, *Circuit Judge*

Various shipper interests petition pursuant to 28 U.S.C. §§2321, 2342(5) to review an order of the Interstate Commerce Commission (ICC) adopting a standard of revenue adequacy for market dominant carriers.[1] Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981). Several carrier interests petition to review the same order.[2] The shipper interests contend that in several respects the order is more generous to the carriers than the law permits. The carrier interests, while generally defending the order, contend that the ICC erred in its treatment of rail properties currently unused or unuseful. We hold that the carrier petition presents issues not ripe for judicial review. As to the petitions of the shipper interests, we affirm the ICC order.

I.

The Regulatory Scheme

In 1976, confronting the total collapse of the railroad industry in the Northeast, Congress enacted the Railroad Revitalization and Regulatory Reform Act. Pub. L. No. 94-210, 90 Stat. 31 (hereinafter 4R Act). Two salient features of that legislation are relevant to the disposition of the instant petitions.

The first is the provision that "[n]otwithstanding any other provision of this part, no rate shall be found to be just and reasonable, on the ground that such rate exceeds a just or reasonable maximum for the service

1. The shipper petitioners include businesses dependent upon, or trade organizations whose members are dependent upon, rail shipment of bulk commodities such as coal, iron ore, chemicals, and pulpwood.

2. The carrier petitioners include Bessemer and Lake Erie Railroad Company and the Association of American Railroads.

rendered or to be rendered, unless the Commission has first found that the proponent carrier has market dominance over such service." Pub. L. 94-210, §202(b), equivalent codified at 49 U.S.C. §10701a(b)(1) (1982). The effect of this provision was to end for most rail service decades of ICC control over maximum rates and to permit carriers not having market dominance to set rates in response to their perception of market conditions. Market dominance was defined as "an absence of effective competition from other carriers or modes of transportation, for the traffic or movement to which the rate applies." Pub. L. 94-210, §202(c)(i). *See* 49 U.S.C. §10709(a)(1982). The ICC has determined that there is effective competition for the traffic or movement to which a rate applies from (1) carriers or modes of transportation, serving the same origin and destination; (2) carriers or modes of transportation delivering the same product from the same origin to alternative destinations; (3) carriers or modes of transportation delivering the same product to the same distination from alternative origins; and (4) carriers or modes of transportation delivering substitute products to the same destination, irrespective of origin. 49 C.F.R. Part 1109; Ex Parte No. 320 (Sub-No. 2), *Market Dominance Determinations and Considerations of Product Competition*, 365 I.C.C. 118, 129 (1981). Thus the category of market dominant carriers is a narrow one, involving services to shippers who by virtue of location and inability to use substitute products are captive customers of a rail carrier.

The second salient feature of the 4R Act is the enactment of a section dealing with the standard for ratemaking for those market dominant carriers still subject to ICC ratemaking jurisdiction. Section 205 of that Act directed the ICC "within 24 months after the date of enactment of this paragraph, after notice and an opportunity for a hearing, [to] develop and promulgate (and thereafter revise and maintain) reasonable standards and procedures for the establishment of revenue levels

adequate under honest, economical, and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a fair, reasonable, and economic profit or return (or both) on capital employed in the business." Congress directed, further, that "[s]uch revenue levels should (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation and (b) insure retention and attraction of capital in amounts adequate to provide a sound transportation system in the United States."

Acting under the mandate of Section 205 the Commission conducted two revenue adequacy proceedings, to which more particular reference will be made hereafter.[3] Meanwhile two major midwestern railroads went bankrupt, necessitating emergency federal legislation.[4] Congress, apparently dissatisfied with the pace of the ICC's revenue adequacy proceedings, passed the Staggers Rail Act of 1980, Pub. L. 96-448, 94 Stat. 1895 (hereinafter the Staggers Act). That Act amended the 4R Act in several respects. In an effort to increase railroad revenues, it created zones of rail carrier rate flexibility in which even market dominant carriers, if found to be revenue inadequate, could increase rates without ICC approval.[5] The Staggers Act also amended

3. Ex Parte No. 338, Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels, 358 I.C.C. 844 (1978); Ex Parte 353, Adequacy of Railroad Revenue (1978 Determination), 361 I.C.C. 79 (1978); 362 I.C.C. 199 (1979).

4. See Rock Island Transition and Employee Assistance Act, Pub. L. 96-254, 94 Stat. 399 (1980); Milwaukee Railroad Restructuring Act, Pub. L. 96-101, 93 Stat. 736 (1979).

5. Pub. L. 96-448 §203. Revenue inadequate carriers were authorized to increase rates on services otherwise subject to ICC rate control as follows:

> (c)(1) During the 12-month period beginning on the effective date of the Staggers Rail Act of 1980 and during each of the 3 succeeding 12-month periods, a rail carrier may, in addition to rate increases authorized under subsection (b) of this sec-

section 205 of the 4R Act to provide that "[t]he commission shall maintain *and revise as necessary* standards and procedures for establishing revenue levels." Pub. L. 96-448, §205(b)(1). Moreover the ICC was directed to conclude a section 205 proceeding within 180 days after

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tion, increase any rate over which the Commission has jurisdiction under section 10709 of this title by an annual amount of not more than 6 percent of the adjusted base rate, except that in no event shall the total increase under this subsection result in a rate which is more than 118 percent of the adjusted base rate.

(2)(A) If any portion of a rate increase under this subsection is not implemented in the year in which it is authorized, such portion may, except as provided in subparagraph (B) of this paragraph, be implemented only in the next succeeding year.

(B) If any portion of the total rate increase authorized under this subsection is not implemented by the end of the 4-year period beginning on the effective date of the Staggers Rail Act of 1980, such portion may be implemented in the next 2 succeeding years, except that in no event may a rail carrier increase a rate under this subsection or under subsection (d) of this section in either of such 2 succeeding years by an annual amount of more than 10 percent of the adjusted base rate.

(d)(1) Except as provided in paragraph (3) of this subsection, during the 12-month period beginning on October 1, 1984, and during each succeeding 12-month period, a rail carrier may, in addition to rate increases under subsection (b) of this section, increase any rate over which the Commission has jurisdiction under section 10709 of this title by an annual amount of not more than 4 percent of the adjusted base rate.

(2) No portion of any rate increase under this subsection which is not implemented in the year in which it is authorized may be implemented in any other year.

Additionally, section 203 created "zones of rail carrier rate flexibility. 49 U.S.C. §10707a.

(c)(1) Any rail carrier rate which increased over 70 percent between 1976 and 1979 inclusive for the transportation, in shipper owned equipment over a distance exceeding 1,550 miles between points within the United States, of coal pursuant to a tariff calling for an annual volume of more than 2,000,000 tons per year purchased by a municipally owned utility for the generation of electric power under a 20-year purchase agree-

the effective date of the Staggers Act. Pub. L. 96-448 §205(b)(3). The effect of an ICC determination that a carrier is revenue inadequate, therefore, is to permit rail carriers to raise rates on services as to which they have market dominance, without ICC approval, within the zones of flexibility specified in the statute.

II.

The ICC Decision

Ex Parte No. 393 which we review is the ICC's response to the Staggers Act direction that it conclude a section 205 proceeding within 180 days. On December 3, 1980 the ICC issued a notice proposing to repeal its governing revenue adequate regulations and to adopt a new standard measure. 45 Fed Reg. 80150 (1980). Departing from the approach it took in two prior revenue adequacy proceedings, it determined that a railroad would be considered revenue adequate when it received a rate of return on net investment equal to the current cost of capital. It determined to measure current cost of capital by examining current cost of debt, rather than embedded or historical cost of debt, together with cur-

NOTE—Continued

ment entered into by such utility in the year 1974 shall not be increased so long as coal is purchased under such original agreement, except that —

(A) during the period beginning October 1, 1980, and ending September 30, 1987, the Interstate Commerce Commission may permit increases in such rate which result in a revenue-variable cost percentage of not more than 162 percent; and

(B) after October 1, 1987, such rate shall be subject to section 10701a of title 49, United States Code, and related provisions of such title governing regulation of rail carrier rates, except that until such rate results in a revenue-variable cost percentage that is equal to or greater than the revenue-variable cost percentage applicable under section 10709(d) of such title, such rate may not be increased more than 4 percent, in addition to inflation, in any year.

rent cost of equity. In determining the rate base the ICC included reserves for deferred taxes, authorized use of betterment accounting for valuation of track assets, valued other assets at depreciated book value, and included in the investment base unused and unusable rail assets. In calculating the cost of capital and rate base the ICC used the most recent data available; the operating results and cost of capital for 1979.

The adoption of current cost of capital as the sole rate of return standard is a modification of the approach taken by the ICC in Ex Parte No. 338, the first of its section 205 proceedings. In that case the commission indicated that "[a]dequate revenue determination for railroads, . . . should not be based simply on a rate of return at the cost of capital rate." 358 I.C.C. at 872. It also proposed to consider certain financial ratios as indicative of a railroad's ability to raise capital. These included fixed charge coverage, proportion of debt in the capital structure, return on shareholders' equity, and ratio of market value of common stock to book value. 358 I.C.C. at 859. Moreover the ICC proposed to use flow of funds analysis, which projects needed capital outlays and other fund requirements, determines funds available from operations and capital sources, and ascertains the extent to which such funds will fall short of projected fund requirements. This group of standards were also utilized in Ex Parte 353. 361 I.C.C. 79 (1978), 362 I.C.C. 199 (1979). In Ex Parte 393 the ICC justifies its elimination of the consideration of ratios, and of flow of funds analyses, as inappropriate indicators of long term revenue adequacy. 364 I.C.C. at 817.

III.

Scope of Review

The ICC's revenue adequacy standard is a product of notice and comment rulemaking. 5 U.S.C. §553(c). The rulemaking proceeding was unquestionably within

the ICC statutory jurisdiction. We may set aside its action, therefore, only if it is arbitrary, capricious, an abuse of discretion, or otherwise not according to law, or if it was adopted without observance of procedure required by law. 5 U.S.C. §706(1)(A),(D). We may not weigh the evidence before the ICC, or inquire into the wisdom of the promulgated regulations, and we may inquire into the soundness of the ICC's reasoning only to the extent of ascertaining that its conclusions are rationally supported. *United States v. Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 749 (1972); *Baltimore and O.C.T.R.Co. v. United States*, 583 F.2d 678, 685 (3d Cir. 1978). Moreover, even when ICC rulemaking represents a departure from that agency's prior position, so long as the policies it is pursuing can be discerned from its opinion, and those policies are consistent with congressional directives, we must defer to the ICC's agency judgment. *Atchison T. & S.F. R. Co. v. Witchita Bd. of Trade*, 412 U.S. 800, 809 (1973). The choice by an agency among alternative means for satisfying a statutory mandate, is exclusively for that agency. Within the limits of this highly deferential scope of review, we turn to the petitioners several objections.

IV.

The Shipper Objections

The shipper objections may conveniently be divided into two categories; those bearing upon the ICC's adoption of a single rate of return standard for revenue adequacy, and those bearing upon determination of the rate base against which that return is calculated. We address them in that order.

A. The Standard of Revenue Adequacy

In Ex Parte 393 the ICC supported its conclusion that the standard for revenue adequacy should be a rate of return equal to the cost of capital by noting:

> Such a standard is widely agreed to be the minimum necessary to attract and maintain capital in the railroad, or any other, industry. The cost of capital is the rate of return required of a firm by current and prospective holders of its securities. If a firm is unable to earn the cost of capital, investors will be unwilling to supply capital to it. (footnote omitted).

364 I.C.C. at 809. The ICC reviewed the verified statement of William J. Baumol, which it credited, that any decision which foreclosed the opportunity to earn a compensatory rate of return on a railroad's capital would guarantee deterioration of plant and equipment, neglect of replacement and opportunities for modernization, and withdrawal of railroad services valued by customers. It then reasoned:

> Railroads can obtain funds for investment only by offering rates of return comparable to other investment opportunities. Otherwise, investors will elect to invest their funds elsewhere. If railroads earn less than adequate rates of return because of inappropriate regulatory action, rather than because they are not providing a desired service, then the standards of the Rail Act and the clear thrust of congressional policy will be thwarted.
>
> The minimum rate of return that will allow railroads to obtain investment funds is the cost of capital. The cost of capital is, by definition, the rate at which the market values investment funds. As we have said, investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding because investors will have sufficient opportunities to invest their funds elsewhere at a higher rate of return. It is extremely important to add, however, that this is true of funds generated internally as well. Railroad management has little incentive to reinvest funds generated by ratepayers in continued rail use if greater re-

> turns are available elsewhere. Railroads are private companies whose stockholders would not permit such reinvestment. Thus, even retained earnings will not be invested in the company if they cannot earn a rate of return equal to the cost of capital.

364 I.C.C. at 810.

The shipper interest mount several attacks upon the decision to opt for a single standard, some procedural and others substantive.

1. Adequacy of Notice

Some shippers contend that the ICC notice of proposed rulemaking published in the Federal Register, 45 Fed. Reg. 80150 (1980) did not comply with 5 U.S.C. §553(b)(3). That section requires notice "either of the terms or substance of the subjects and issues involved." We have held that the statute requires a notice in sufficient detail to alert properly all interested parties as to important particulars affecting them, and thus to permit those parties to comment before being subjected to regulations. *Marshall v. Western Union Telegraph Company*, 621 F.2d 1246, 1254 (3d Cir. 1980); *American Iron & Steel Const. v. EPA*, 568 F.2d 284, 293 (3d Cir. 1977); *Wagner Electric Corporation v. Volpe*, 466 F.2d 1013, 1019 (3d Cir. 1972). We conclude that the notice adequately complied with the standards for notice laid down in this court's caselaw. Plainly it alerted shipper interests that the ICC perceived difficulties with the use of ratios, and flow of funds analyses. Moreover it gave explicit notice that the ICC considered the current cost of capital to be the "minimum rate necessary to attract and maintain capital in the railroad, or any other industry." 45 Fed. Reg. at 80152. That no more explicit notice was required is confirmed by an examination of the detailed comments actually received.

2. Absence of Codification

Some shippers contend that the ICC violated 79 U.S.C. §10704(a)(2), which requires that it "maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers," by declining to codify its revenue adequacy standards. The ICC held, and we agree, that neither the 4R Act as amended by the Staggers Act, nor any provision of the Administrative Procedure Act requires a specific format for a revenue adequacy determination. The agency provided notice in the Federal Register and an opportunity for comment. It published its decision, and provided Federal Register notice of its issuance. The public has been adequately informed as to how the ICC will make determinations of revenue adequacy. Codification in the Code of Federal Regulations might be appropriate, but certainly is not essential to the legality of the decision in Ex Parte No. 393.

3. Legality of a Single Standard

The shipper interests maintain that in adopting a rate of return equal to the current cost of capital as the single standard for revenue adequacy the ICC misinterpreted section 205. They point out that the only change which the Staggers Act made in section 205 of the 4R Act was the addition of the language "revise as necessary." This language, they urge, while it did contemplate possible revisions of the revenue adequacy standards announced in Ex Parte No. 338 and No. 353, did not mandate the elimination of ratios or of flow of funds analyis. Those standards, they insist, were required by section 205 as it originally appeared in the 4R Act. Chief reliance is placed on the sentence:

> Such revenue levels should (a) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure repayment of a reasonable level of debt, permit the raising of needed equity capital and cover the effects of inflation and (b)

> insure retention and attraction of capital in amounts adequate to provide a sound transportation system in the United States.

Reliance is also placed on the reference in the prior sentence to "honest, economical and efficient management." Pub. L. 94-210 §205(2). In support of their interpretation of the quoted language the shippers refer to language in Senate and House reports on the 4R Act. The Senate report explains:

> In considering adequate revenue levels, the Commission will be expected to utilize the most modern financial techniques available and to adopt a prospective view of carrier revenue needs. Previous analysis of the adequacy of regulated industry revenues has focused upon adequate returns on investment. While this type of analysis may need to be continued, it is equally important for the Commission to focus on the level of revenue needed to provide and maintain adequate service in the public interest. This requires emphasis upon present and future revenue levels under honest, economical and efficient management as opposed to a theoretically adequate rate of return on investment that may have no relationship to the need for operating and capital funds necessary to maintain service in the public interest.

S. Rep. No. 94-499: Report to the Senate Committee on S. 2718, Rail Services Act of 1975, November 26, 1975, pp. 51-52. House Report No. 94-725, 94th Cong. 1st Sess. 73 (1975) states:

> In carrying out one of the primary objectives of this legislation, the reported bill amends . . . the Interstate Commerce Act . . . to require that the Commission establish standards for the establishment and maintenance of adequate revenue levels for railroads . . . . Needless to say, in establishing

> such standards, the Commission shall take into consideration productivity factors and financially sound debt and equity ratios.

The shippers contend that in light of this legislative history section 205 must be read as requiring separate standards addressed to financial ratios, to flow of funds analysis, and to productivity. They make this contention, obviously, in hopes that utilization of these additional standards will produce a level of revenue adequacy lower than that resulting from application of the current cost of capital standard. This, they hope, will prevent more carriers from taking advantage of the zones of rate flexibility in 49 U.S.C. §10707a. The shippers do not dispute that the ICC standard will provide an opportunity to attain revenue levels at least equal to those which might be authorized if the other proposed standards were employed.

The ICC interprets section 205 differently. It concludes that the section was addressed to the *opportunity* to attain revenue levels which would reverse the long decline in the railroad industry. The specific objectives listed in section 205 should not in its view be read as limitations on revenue, and may all be attained under the current cost of capital standard. The ICC urges, as well, that the Staggers Act was intended to create a regulatory environment more favorable to investment in railroads. Congress' concern was "to reform Federal regulatory policy so as to preserve a safe, adequate, economical, efficient and financially stable rail system" and "to assist the rail system to remain viable in the private sector of the economy." Pub. L. 96-448, §§3(2) and (3), 94 Stat. 1897. Despite the use of financial ratios and of flow of funds analysis in Ex Parte Nos. 338 and 353, the economic difficulties of the railroad industry continued under the 4R Act. Thus, the ICC points out, adoption of the more all encompassing current cost of capital standard was suggested by experience. As to productivity and honesty in management, it reads the statutory

references to those matters as expressions of concern that carriers with honest, economical and efficient management have the opportunity to achieve adequate revenues. If the management is not honest, economical and efficient it will not, despite such opportunity, attract capital or retain business.

Given the highly deferential scope of review by which this court is confined, we cannot hold that the adoption of a single standard encompassing the objectives listed in section 205 must be set aside. The overall policy pursued by the agency is entirely consistent with Congressional directives. Reasons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis, and for refraining from incorporating productivity standards under section 205, have been carefully explained. While some other standard or combination of standards might also accomplish the overall objectives of the 4R and Staggers Acts, the choice among permissible alternatives is to be made by the agency to which rulemaking authority has been delegated, not by this court.

The shippers urge that the ICC's interpretation of section 205 puts them, as customers of market dominant carriers, entirely at the mercy of those carriers. That contention ignores the distinction in the statute between revenue adequacy proceedings and rate reasonableness proceedings. Carriers deter mined to be revenue inadequate may, without ICC approval, raise rates within the zones of reasonableness set out in 49 U.S.C. §10707a. Individual shippers who object to specific rates may file complaints against market dominant carriers challenging the reasonableness of such rates. 49 U.S.C. §§11701(b), 11705. In such proceedings the ICC retains authority to prevent imposition of unreasonable rates on market dominant traffic. Among the factors which it may consider in rate reasonableness proceeding are the inefficiency or dishonesty of the carriers' management, and discrimination in rates which may result in subsi-

dizing competitive traffic with charges imposed on captive shippers. As the ICC points out, a revenue adequacy determination is no guarantee that any carrier will attain any level of revenue.

Thus, we conclude that the ICC's adoption of the single standard of revenue adequacy — a rate of return equal to the current cost of capital — is consistent with section 205, and is not arbitrary, capricious, or an abuse of discretion.

4. Current vs. Embedded Debt

Perhaps the most strenuously voiced shipper objection to the ICC's standard is its reliance on current cost of debt capital instead of cost of embedded debt. The shippers do not object to looking to the current market for the proper return on equity investment. Nor do they object to the ICC's assumptions about a proper ratio between debt and equity investment in the railroad industry. They do object, however, that by looking to the current cost of debt, when many carriers owe debt which was contracted for years ago at lower interest rates, the ICC is affording to the stockholders the opportunity to make a return on investment represented by debt in excess of its cost.

The ICC's position is entirely consistent with section 205, and with the overall scheme of regulation of the 4R and Staggers Acts. In an unregulated industry it would be the object of management, by judicious resort to borrowed funds, to make capital investments which properly utilized would earn in excess of the cost of borrowed funds, thereby providing leverage for stockholder investors. Public utility regulation, by contrast, provides for an assured rate of return to regulated monopolies. In fixing an assured rate of return, it is not unfair to take into account only the embedded cost of debt. Railroad regulation by the ICC, is not, however, classic public utility regulation. For the most part railroads operate in a

competitive environment. It is true that under the 4R and Staggers Acts they are subject to regulation of rates for market dominant traffic. They are not, however, assured of a compensable rate of return even on the investment required to serve that traffic. The purpose of the revenue adequacy determination required by section 205 is to determine which railroads may resort to the flexibility in raising rates provided for elsewhere in the statute. Revenue from all traffic, competitive as well as market dominant, is taken into account for that purpose. There is no reason to suppose that Congress intended to restrict railroads having market dominance in specific instances to a level of revenue determined by its embedded cost of debt service. Such an interpretation of the statute would be inconsistent with the expressed intent of opening capital markets to the railroads, and of encouraging reinvestment of internally generated funds. If the railroads could not gain a rate of return on investment represented by old debt in excess of the old interest rates on such debt, they would be unlikely to attract new equity capital, and their shareholders would insist on investment of internally generated funds outside the rail industry.

Several shippers contend that by using current cost of debt in the revenue adequacy determination the ICC will tend to overcompensate carriers in time of high interest rates, while undercompensating them when their embedded interest rates exceed current rates. We have already rejected the contention that the carriers may not enjoy leverage resulting from judicious earlier borrowing. As to the effect of the ICC's standard should interest rates collapse, the shippers' expressed concern is unrealistic. If old debt carries interest rates exceeding the current market, prudent management will replace it with new borrowings.

Thus, we conclude that the ICC decision to use current cost both of debt and of equity capital in determining an adequate rate of return is consistent with section

205, and is not arbitrary, capricious, or an abuse of discretion.

B. The Investment Base

The shipper interests contend that several ICC rulings with respect to determination of the investment base to which its rate of return shall be applied are arbitrary, capricious, an abuse of discretion, or contrary to law.

1. Use of Betterment Accounting for Track Structures

In its notice of proposed rulemaking the ICC proposed using the sum of original cost plus betterments for the valuation of track structures, explaining that such numbers are readily available for railroads, while capitalized maintenance and depreciation numbers are not.[6] 45 Fed. Reg. at 80152. For all accounts using depreciation accounting it proposed using depreciated book value. *Id.* Several shippers urge that the ICC should have adopted depreciation accounting for track structures as well as for other assets, because betterment accounting may lead to overgenerous estimates of the value of an in-

6. The ICC has explained betterment accounting as follows:

> Under [betterment accounting], the initial track installation cost is capitalized. This investment is not depreciated and remains in the property investment account until the track is abandoned under the theory that the track structure is maintained in a constant condition and depreciation expense would equal track maintenance costs. Instead of depreciation, track replacements are accounted for as track maintenance expenses, except if through the application of superior component parts (such as replacing 110-lb. rail with 132-lb. rail) a betterment occurs. In that instance, the excess cost of new parts over the current cost of new parts of the kind replaced is capitalized.

Alternative Methods of Accounting for Railroad Track Structures, 46 Fed. Reg. 32289 (1981).

vestment base, and to inaccurate reports of railroad profits. Although the ICC has recently indicated a willingness to reconsider the use of betterment accouting, in Ex Parte 393 it concludes:

> In continuing to think about this issue, we have grown more convinced that betterment accounting may underestimate — not overestimate — the value of the investment base. Track structure is valued at the original cost of the track at the time the original investment was made, plus betterments (valued at their original cost). Under depreciation accounting, track structure would continually be revalued. Due to inflation, track structure would, therefore, likely be valued at a higher level under depreciation accounting because its value is set at a later date.

364 I.C.C. at 812. The ICC acknowledged that the practice of considering all track maintenace except betterments to be an expense could overstate profits in periods of low maintenance and understate profits in periods of high maintenance. It concluded that it lacked information as to the direction or magnitude of these distorting effects, and that the betterment accounting data are the best currently available. *Id.* at 813.

Considering our limited scope of review, the industry practice of using betterment accounting for track structures, and the Congressional direction to the ICC in the Staggers Act to complete a revenue adequacy proceeding in 180 days, we cannot hold that the agency's decision to calculate the value of track structures by betterment rather than depreciation accounting should be set aside.

2. Failure to Exclude Unused or Useless Assets from the Rate Base

Some shippers urge that the ICC erred in failing to exclude from the railroads' ratebase assets which have not been formally abandoned, but which are neverthe-

less unused or useless. The statutory standard is "a reasonable and economic profit or return (or both) on capital employed in the business." 49 U.S.C. §10704(a)(2). In deference to that standard the ICC noted that it "must be careful not to overvalue the investment base by including in it assets that are neither used nor useful." 364 I.C.C. at 811. But because the Staggers Act required a revenue adequacy determination within 180 days the agency found it impossible to distinguish used and useful plant from that which was neither. It advanced two justifications for inclusion of all assets not formally abandoned at original cost plus betterments for track assets, and depreciated book value for all other assets. First, it found that the book value of unused and unuseful assets was significantly less than one percent of total net investment. Second, it found that railroads with the highest percentage of abandonable lines have had low profits, and thus are likely to be found revenue inadequate in any event. There is evidence in the record supporting both findings.[7]

We conclude that in determining for purposes of section 205 what capital is "employed in the business" of a railroad, the ICC has acted within the bounds of the discretionary authority conferred on it by Congress. The agency noticed for comment the question of possible unused and unuseful assets. 45 Fed. Reg. 80152-53. On the basis of information submitted in response to the notice it concluded that no adjustment to the book values of the investment base was necessary at this time, because no likelihood of substantial overvaluation was established. Thus we hold that the failure to calculate and exclude value of unused or unuseful assets, for purposes of the initial revenue adequacy determination mandated by the Staggers Act, was not arbitrary, capricious, or an abuse of discretion.

7. Statement of Charles W. Hoppe. "The Extent of Excess Capacity," V.S. #3, Comments of American Association of Railroads, at 7-8.

3. Reserves for Deferred Taxes

Under the Internal Revenue Code railroads, like other businesses, are permitted to take accelerated depreciation deductions. 26 U.S.C. §167(b). The effect of accelerated depreciation is to leave in the business, temporarily, funds which under normal depreciation funds accounting methods would be paid out as taxes on earnings. The tax benefit, assuming continuing profitable operations, is temporary, since in later years the unavailability of depreciation allowances on assets for which accelerated depreciation was elected results in higher income. In effect, by deferring the collection of taxes the federal government makes a temporary investment in the business.

The shipper interests contended before the ICC, and urge here, that reserves for deferred taxes should be excluded from the rate base. In making this argument, they urge adoption by the ICC of an accountng procedure utilized by some public utility regulatory bodies called normalization. Normalization means that a regulated utility, while it may calculate its tax liability using accelerated depreciation, must for rate making purposes report depreciation and earnings on a straight-line basis. *See* E. Warren, *Tax Accounting in Regulated Industries Limitations on Rate Base Exclusions*, 31 Rutgers L. Rev. 187, 190 (1978). Normalization accounting results in passing through to utility customers the tax savings resulting, temporarily, from accelerated depreciation.

In many respects the shippers' plea for normalization accounting for depreciation is similar to their plea for use of embedded rather than current cost of debt. By not deducting from the rate base a reserve for unpaid taxes, the ICC is permitting the railroads to earn for their stockholders a return on money the United States has temporarily invested in the enterprise. Since those funds are cost free, according to the shippers, no rate of return should be allowed on them.

The simple fact remains, however, that for all businesses accelerated depreciation is a source of funds which may be reinvested. If the railroad industry were to be put in the position that unlike unregulated industries it could not earn a rate of return on investment of such funds it would be at a competitive disadvantage in seeking equity capital, and it would be encouraged to invest the funds generated from accelerated depreciation elsewhere than in the railroad business. Perhaps in balancing the competing interests for shippers and rail carriers a commission decision excluding reserves for deferred taxes from the rate base would be a defensible interpretation of section 205. Indeed that was the ICC's earlier position.[8] In Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines Nationwide*, 364 I.C.C. 360 (1980), however, it reconsidered that position. Both in that case and in Ex Parte 393 it recognized that excluding deferred taxes from the ratebase would provide an incentive for railroads to invest in non-rail assets. It would, moreover, produce a rate of return below the cost of capital, since capital markets act with knowledge of the availability of accelerated depreciation as a source of funds.

The ICC's position on normalization of depreciation accounting is rationally supported. Its reasons for departure from its prior position are adequately explained, and its present policy is consistent with the Congressional directive in section 205. We may not disturb its decision in respecting reserves for deferred taxes.

V.

Carrier Objections

Some carriers object that the ICC opinion recognizing that some rail lines are so unused or unusable as to be potentially abandonable, intimated that in the future it might determine that unused or unusable lines ought

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8. See San Antonio Texas v. United States, 631 F.2d 831, 847 (D.C. Cir. 1980).

to be excluded from the rate base for purposes of revenue adequacy determinations. They contend that so long as they are under a legal obligation to retain rail property, whether or not it is used or useful, its book value must as a matter of law be included as "capital employed in the business." 49 U.S.C. §10704(a)(2). The ICC points out, correctly, that no abandonable properties were excluded from the rate bases dealt with in Ex Parte 393. In its opinion the ICC observed:

> We have . . . decided, for purposes of this initial assessment, to use a method of asset valuation that does not explicitly address the question of identifying used and useful plant. We do this only because we believe such identification is not possible in the time allowed and because we believe that the valuation that will result from use of the method we are adopting is accurate.

364 I.C.C. at 811. Whether in the future any potentially abandonable properties will be excluded from the rate base is, at this point, entirely a matter of speculation. Thus we conclude that the shipper petition for review challenging the legality of any such exclusion presents an issue which is not ripe for judicial review. *Abbott Laboratories v. Gardner*, 387 U.S. 136 (1967); *West Penn Power Co. v. Train*, 522 F.2d 302 (3d Cir. 1975).

The carrier interests also urge that the ICC erred when in deciding Ex Parte 393 it relied upon cost of capital and operating results for 1979. Under the strict deadline for decision included in the Staggers Act, however, the ICC had no real choice but to rely on the most recent figures on operating results which were available; those for 1979. It could have relied upon information about capital costs in 1980, but its decision to utilize capital costs for the same year as the operating results upon which its revenue adequacy determinations were to be based was not an abuse of discretion.

VI.

Conclusion

The decision of the ICC in Ex Parte 393, 364 I.C.C. 803 (1981) will be affirmed in all respects.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

APPENDIX B

INTERSTATE COMMERCE COMMISSION

EX PARTE NO 393

STANDARDS FOR RAILROAD REVENUE ADEQUACY

Decided March 26, 1981

Repeals existing standards and establishes as the standard of revenue adequacy a rate of return equal to the cost of capital.

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DECISION

BY THE COMMISSION

By notice served November 26, 1980, the Commission proposed that existing rules be repealed and new standards adopted for determining railroad revenue adequacy. These changes were proposed to enable the Commission to implement section 205 of the Staggers Rail Act of 1980 (Rail Act).

BACKGROUND

Section 10704(a)(2) of the Interstate Commerce act requires the Commission to maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers adequate to cover total operating expenses, including depreciation and obsolescence, plus a reasonable return on capital. The act also states that adequate revenue levels should:

> (a) provide a flow of new income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and
>
> (b) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

Section 205(b)(2) of the Rail Act amends 49 U.S.C. 10704(a) by adding a new paragraph (3) directing the Commission to conclude a proceeding under 49 U.S.C. 10704(a)(2) within 180 days after its effective date. Section 205(b)(2) also adds a new paragraph (4) directing the Commission to determine which rail carriers are earning adequate revenues within the same 180-day period, and on an annual basis thereafter.

As discussed in the notice, the concept of revenue adequacy is important throughout the Rail Act. Section 101(a) of the Rail Act states that in regulating the railroad industry, it shall be the policy of the United States to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues. Section 201(a) of the Rail Act states that in determining whether a rate established by a rail carrier is reasonable, the Commission shall recognize the policy that rail carriers shall earn adequate revenues. The zone of rate flexibility established by section 203 of the Rail Act may not be available after October 1, 1984, to carriers earning adequate revenues. Those carriers may not use the 4-percent zone above the adjusted base rate for single-line rates and, in all likelihood, joint-line rates. That section also provides that complaints challenging the reasonableness of rates increased under the zone are judged differently when they involve carriers with adequate revenues. Section 217(a)(1) of the Rail Act allows carriers not earning adequate revenues to have greater freedom in applying surcharges to joint rates.

In the notice, the Commission stated that adequate revenues should cover a railroad's costs plus an adequate rate of return on its investment base. The proposed standards separately considered the issues of adequate rate of return and valuation of the investment base. Comments were sought on these proposed standards. We also stated that we believed that individual railroads needed to be in sound financial condition in order for their revenues to be deemed adequate. The proposed standards contem-

plated using the operating ratio, the fixed charge coverage ratio and the throwoff-to-ratio as means of determining whether individual railroads are in sound financial condition. Public comment was requested as to whether standards regarding financial soundness are useful in assessing revenue adequacy, and whether the proposed measures are the most appropriate for this purpose.

We said that after considering comments filed in response to the notice, we would publish a final notice setting forth standards for determining railroad revenue adequacy and would employ those standards to determine which railroads are earning adequate revenues. These standards and the resulting individual railroad determinations are set forth here.

PRELIMINARY MATTERS

Several parties contend that we are not conducting this proceeding in accordance with Administrative Procedure Act (APA). The basis inconsistency alleged is that the notice of proposed rules was insufficient to give the public an opportunity for meaningful comment. Cited in particular were the lack of specific rules in the notice and an alleged lack of rationale for our departure from the Ex Parte Nos. 338 and 353 standards.

Section 553 of the APA sets our three procedural requirements for rulemaking proceedings: notice of the proposed rulemaking, an opportunity for interested persons to comment, and a statement of the basis and purpose of the rules ultimately adopted. *Home Box Office, Inc.* v. *F.C.C.*, 567 F. 2d 9, 35 (D.C. Cir. 1977), cert. denied, 434 U.S. 829 (1977). There is no stated requirement that notices be formulated in terms of specific rules. Rather, section 553 specifies instead that either the terms or substance of the proposed rule or a description of the subjects and issues involved shall be included in the notice.

Whether a notice adequately satisfies this requirement must be tested by determining whether the notice would fairly appraise interested persons of the subjects and issues before the agency. *American Iron & Steel Inst.* v. *Envir. Prot. Agency*, 568 F. 2d 284, 293 (3d Cir. 1977); *National Indus. Traffic League* v. *United States*, 396 F. Supp. 456, 460 (D.D.C. 1975). In other words, the notice must allow an exchange of views, information, and criticism between interested persons and the agency. *Home Box Office, Inc., supra.*

Our notice of proposed rulemaking satisfied these criteria. It is clear from the notice that the subjects and issues to be considered included the impact of the Rail Act on revenue adequacy standards, the use of rate of return as a standard, valuation of the investment base, and the use of

financial ratios in revenue adequacy determinations. Furthermore, the notice, by referring to our prior lengthy decision on revenue adequacy, provided background material and demonstrated that the concepts discussed were already familiar to the agency and the public. That the notice was sufficient to allow public comment and agency response is indicated not only by the volume of comments received, but by our discussion of these comments throughout this decision.

Various parties also contend that rules published in the Code of Federal Regulations (CFR) are required either under the APA or as a result of the requirement in section 10704(a)(2) that the Commission maintain standards and procedures for establishing adequate revenue levels. We disagree. Neither the APA nor section 10704(a)(2) specifies the format which our standards must take. See, *e.g.*, section 552 of the APA which requires only that publication be made in the Federal Register. The decision here concludes that the appropriate standard is a return on investment equal to the cost of capital, and describes the methodology used to calculate present returns on capital. That decision, along with a Federal Register notice of issuance of the decision, is sufficient to inform the public as to how we will make determinations of revenue adequacy.

We have also indicated in this decision an intent to consider major modifications in our revenue adequacy methodology in future revenue adequacy proceedings. Thus rules published in the CFR would be particularly inappropriate at this time.

The argument that the notice does not provide sufficient rational for the proposed changes is also not convincing. Most of the cases cited by the parties on this question involved the adequacy of the rational for final decisions rather than for proposed rules. The APA also emphasized the importance of a statement accompanying final rules on the basis and purpose of the rules.

In any case, the notice did indicate that prior revenue adequacy decisions had discussed a range of standards, that various standards could be used for various purposes, and that the purposes of the newly enacted Rail Act could best be achieved by the standard proposed in the notice. Furthermore, another section of the decision here discusses again and in detail our reasons for adopting the proposed standards. We have concluded that these two discussions adequately describe the rationale supporting our decision.

In arguing that we have not complied with APA requirements, parties have cited various cases not discussed above, including *National Motor Freight Traffic Ass'n* v. *United States*, 268 F. Supp. 90 (D.D.C. 1967), affirmed 393 U.S. 18 (1960), *Pacific Gas & Electric Co.* v. *Federal Power Com'n*, 564 F. 2d 633 (4th Cir. 1977), cert. denied 435 U.S. 995 (1978),

and *Pickus* v. *United States Board of Parole*, 507 F. 2d 1107 (D.C. Cir. 1974). As these cases considered the initial question of whether a particular agency action required notice and a comment period, they are not relevant to the issues raised here. Here the issue raised was the adequacy of the notice rather than its necessity.

SUMMARY OF CONCLUSION

The comments submitted in this proceeding have been fully reviewed. Many expressed valid concerns and were thoughtful and useful. Some of the concerns raised are discussed here, but all were carefully considered. After reading and considering the comments, we continue to believe that revenue adequacy standards must be based on a rate of return equal to the current cost of capital.

We discuss below our reasons for modifying the standards set forth in Ex Parte No. 338, *Establishment of Adequate Railroad Revenue Levels*, 358 I.C.C. 844 (1978), 359 I.C.C. 270 (1978) and Ex Parte No. 353, *Adequacy of Railroad Revenue*, 362 I.C.C. 199 (1979), 362 I.C.C. 794 (1979). Several parties expressed the view that the Rail Act does not require the Commission to change its revenue adequacy standards.[1] We agree that the Rail Act contains no such requirement, However, after considering the overall thrust of the Rail Act, and the role it accords revenue adequacy findings, we believe new standards are necessary and appropriate. Specifically, we believe that in order for a railroad to be considered revenue adequate it must be earning a rate of return equal to the current cost of capital. This view is not new. As we stated in the notice instituting this proceeding:

> In Ex Parte No. 338 and Ex Parte No. 353, the Commission established standards and procedures for determining adequate railroad revenue levels. A return on investment equal to the cost of capital was only one of four standards the Commission indicated it would use in considering revenue adequacy. Financial ratios as indicators of financial structure, and flow of funds analyses were among the other standards considered in Ex Parte No. 338 and Ex Parte No. 353. Along with the cost of capital, these standards established a range of revenue adequacy. The range's high value is a measure of the cost of capital. The range's low value results from the use of a funds-flow model. This low value for revenue adequacy, however, does not and was never intended to define a long-term level of adequate revenue.[2] Rather, the low level calculation using funds-flow analysis is applicable only when it is necessary to assure that regulation per se does not provide carriers the current rate of return on redundant plant. Further, this measure conceptually establishes a

[1] These arguments are well summarized in the comments of the Edison Electric Institute, the National Industrial Traffic League, and the Western Coal Traffic League.

[2] We discussed this point at length several times in Ex Parte No. 353. See, for example 362 I.C.C. 223. There, we said, "That is, as unprofitable old investments are retired and new investments are made that earn a cost-of-capital return, a successful carrier's overall rate of return should gradually come to approximate the fair return level." This footnote is footnote 1 in the notice.

minimum level of revenue adequacy. The 4R Act directed the Commission to help carriers achieve adequate revenues. The Ex Parte No. 353 flow of funds determinations represent minimum target levels to be achieved. Revenue adequacy determinations are used differently in the Rail Act. In particular, carriers are denied additional rate flexibility if they are deemed revenue adequate. Thus, the Commission's determination will, to some degree, hold carriers' revenues down to the adequate level. In this context, minimum standards are not appropriate.

We want to make sure these views are stated as clearly as possible because we believe they are very important. We have not made radical changes in the standards of Ex Parte No. 353. Rather, we have adapted those standards in light of the role the Rail Act accords the concept of revenue adequacy. Funds-flow analysis and other minimum standards of revenue adequacy as described in Ex Parte No. 353 were and are appropriate as indicators only of the short-term viability of railroads. They were and are inappropriate as indicators of long-term revenue adequacy and are especially inappropriate as measures to limit rail pricing flexibility which is one of the roles the Rail Act accords revenue adequacy findings. If we adopted the Ex Parte No. 353 minimum or short-term standard for use here, we would likely in the next few years find ourselves denying a railroad the pricing flexibility necessary to obtain long-term revenue adequacy simply because that railroad was making some progress toward achieving that goal. In short, we would be assigning the railroads the Sisphyean task of working toward revenue adequacy, and every time it came close robbing it of the very means it had used to get there. We do not believe this is desirable nor do we believe it was intended by Congress.[3] Thus, our adoption of a rate of return standard is not a radical departure from our previous standards. Ex Parte No. 353 clearly accepted rate of return as a proper standard for ascertaining if a railroad has actually earned adequate revenues. In adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the Rail Act.

We also want to continue to emphasize that a finding of revenue inadequacy does not give a railroad license to set rates at unreasonable levels. As we stated in the notice:

An observation is in order concerning the relationship of revenue adequacy to the zone of rate freedom under section 203 of the Staggers Act. A carrier that lacks adequate revenue may, after October 1, 1984, continue to implement rate increases each year equal to 4 percent of its adjusted base rate. Nonetheless, the Commission may consider the reasonableness of such increases upon the filing of a complaint by an interested party (assuming that the carrier is found to have market dominance). For this purpose, it should be

[3] Congress recognized that our standards might need to be changed. Section 205(b)(1) of the Rail Act authorizes the Commission to "revise as necessary" its revenue adequacy regulations. Also see the Conference Committee Report on section 205 of the Rail Bill.

understood that the computation of an adequate revenue level for the carrier does not represent a guarantee that the carrier will attain such a revenue level. It should not be expected, in other words, that a carrier with inadequate revenue under the proposed standards will have unlimited freedom to raise its rates on market dominant traffic. As we emphasized in Ex Parte No. 353, revenue need is not the only factor to be considered when the reasonableness of a rate is determined.

A Rate of Return Standard

We have decided to consider the issues of adequate rate of return and valuation of the investment base separately. Methods that do not separate these concepts, such as funds-flow analysis, have been discussed in the comments. We have rejected such methods because they rely wholly and uncritically on assumptions about the economic viability of the reasonableness of the return currently earned by the railroads on their current investment base.[4] Instead of using a method of revenue adequacy determination that uses unproven assumptions regarding asset valuation, we will consider this issue directly. While our methods of addressing this issue may not be perfect, we believe they are superior to methods that ignore it.

The standard we will use to measure the adequacy of the rate of return is the current cost of capital. Such a standard is widely agreed to be the minimum necessary to attract and maintain capital in the railroad, or any other, industry.[5] The cost of capital is the rate of return required of a firm by current and prospective holders of its securities. If a firm is unable to earn the cost of capital, investors will be unwilling to supply capital to it. This concept is discussed in detail in the verified statement of William J. Baumol.[6] He argues that "it is essential that regulation provide the *opportunity* for railroads to cover all their costs, including the cost of capital [emphasis in original]." He further argues that "any ICC decision which

[4] In his verified statement for the Western Coal Traffic League, George Borts recognizes that the flow of funds approach addresses neither how much of the investment base is redundant nor the time needed to rationalize it. He believes, however, that this is an advantage. He argues that a funds-flow approach tells us how much a railroad must earn to be viable. As we discussed in the notice, and as the Association of American Railroads (AAR) discusses in their comments the implicit assumption of the Borts method is either that the railroad is already earning an adequate return on the existing investment base or that it can liquidate quickly those portions of its investment base that are not earning an adequate return. A troublesome aspect to this method is that if in applying this approach to a particular railroad neither of these assumptions is accurate, (and in many cases we think it would not be), a railroad earning less than adequate revenues would, nonetheless, be deemed revenue adequate. While it is true that the use of additional standards, such as our proposed financial indicators analyses, may lessen these problems of funds-flow analysis, we believe a method that has such biases is inconsistent with the goals of the Rail Act.

[5] This is a standard principle of economics. See, for example: James M. Henderson and Richard E. Quandt, Microeconomic Theory, 1958, pp. 243-252, or Burton G. Malkiel, "The Debt-Equity Combination of the Firm and the Cost of Capital: An Introductory Analysis," General Learning Press, 1971.

[6] William J. Baumol, "The Economic Principles Governing Rate of Return Regulation," Verified Statement No. 1, comments of the AAR.

forecloses the opportunity to earn a compensatory rate of return on the railroads' capital must guarantee deterioration of plant and equipment, neglect of replacement and opportunities for modernization, and, more generally, withdrawal in one way or another of railroad services which the market would otherwise show to be valued by customers at amounts that exceed their costs." AAR V.S. No. 1, at 1-2.

We agree. Railroads can obtain funds for investment only by offering rates of return comparable to other investment opportunities. Otherwise, investors will elect to invest their funds elsewhere. If railroads earn less than adequate rates of return because of inappropriate regulatory action, rather than because they are not providing a desired service, then the standards of the Rail Act and the clear thrust of congressional policy will be thwarted.

The minimum rate of return that will allow railroads to obtain investment funds is the cost of capital. The cost of capital is, by definition, the rate at which the market values investment funds. As we have said, investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding because investors will have sufficient opportunities to invest their funds elsewhere at a higher rate of return. It is extremely important to add, however, that this is true of funds generated internally as well. Railroad management has little incentive to reinvest funds generated by ratepayers in continued rail uses if greater returns are available elsewhere. Railroads are private companies whose stockholders would not permit such reinvestment. Thus, even retained earnings will not be invested in the company if they cannot earn a rate of return equal to the cost of capital.

Once again, we want to make to clear that we will not and cannot guarantee any railroad a return equal to the cost of capital. A railroad, like any other firm, should earn such a return only if it provides a desired service in an efficient manner. We want to take great care, however, not to deny railroads the opportunity to earn the cost of capital. Again, we agree with Professor Baumol:

> Any firm that is allowed to earn a long-run competitive return will, as a matter of course, be able, to the extent there is demand for its services, to cover all of its costs. It will also (in the words of the statute) have a 'flow of net income sufficient to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, cover the effect of inflation' and to otherwise meet the requirements of the statute. Conversely, it is impossible for a firm that is not earning a long run return equal to the cost of capital to meet these criteria. Most importantly, investor capital, whether purchased through the sale of new equity, or retained from earnings, will not be available in amounts adequate 'to provide a sound transportation system in the United States' unless a firm is earning a return equal to the cost of capital on all capital employed in the business of providing rail services. AAR V.S. No. 1, at 12.

In sum, we conclude that the only revenue adequacy standard consistent with the requirements of the Rail Act is one that uses a rate of return equal to the cost of capital.

USE OF ORIGINAL COST FOR THE INITIAL DETERMINATION

If we are to use the cost of capital to measure rate of return, and rate of return to measure revenue adequacy, then accurately measuring the investment base on which the rate of return is predicated is crucial. In particular, we must be careful not to overvalue the investment base by including in it assets that are neither used nor useful. Unless we eliminate unused and unuseful assets from our calculation, railroads that are, in fact, earning adequate revenues (adequate, that is, to sustain used and useful assets), will be considered to be revenue inadequate. However, the Rail Act requires an initial revenue adequacy determination within 180 days of enactment, and distinguishing used and useful investment from that which is not, is difficult, controversial, and time consuming. We have, therefore, decided, for purposes of this initial assessment, to use a method of asset valuation that does not explicitly address the question of identifying used and useful plant. We do this only because we believe such identification is not possible in the time allowed and because we believe that the valuation that will result from use of the method we are adopting is accurate.

In making our revenue adequacy findings in this proceeding, we have assessed the value of the rate base as the sum of the original cost of track assets plus betterments to track, plus the depreciated book value of all other assets.[7] The advantage of using original cost plus betterments in valuing track structures is that such numbers are readily available for railroads, while capitalized maintenance and depreciation figure are not. For accounts using depreciation accounting (all those other than track-related accounts), we used depreciated book value since such information was readily available.

We considered in the notice whether the failure to identify plant that is not used and useful would make our original cost asset valuation seriously inaccurate, or lead to anomalous results. We said:

> This approach does not explicitly address the question of identifying used and useful plant. That is, the question as to whether and to what extent a railroad's rate base ought to include the capital cost of plant and equipment that will not be renewed is not considered explicitly. Logically, such plant and equipment should be valued at something less than original cost plus betterments. However, given that such investments are likely to be car-

[7] This distinction between track and other assets is necessitated by the fact that we require betterment accounting for track assets, and depreciation for all others. We have used the book value of betterments as currently defined under betterment accounting procedures.

ried on the firm's books at a low original cost and are unlikely to have been bettered, we believe that the use of this approach will result in only a minor distortion. Notice at 10.

Data presented in this proceeding support this belief. In his verified statement, Charles W. Hoppe estimates the book value of lines in categories 1 and 3[8] of railroads' system diagram maps (those that have been identified as likely candidates for abandonment or have actually been proposed for abandonment) as significantly less than 1 percent of total net investment.[9] Further, Mr. Hoppe notes that the railroads with the highest percentage of abandonable lines have low profits and are not likely to be found to have adequate revenues even if the value of such lines were immediately written down to zero. We thus conclude that including plant that is not used and useful in the investment base is not likely to cause a significant overestimate of the original cost value of the investment base.

In the notice, we expressed concern that the use of betterment accounting might also lead to biased estimates of the value of the investment base. In proposing to use the sum of original cost plus betterments to arrive at a valuation of track structures, we noted that:

This corresponds to standard regulatory rate base formulations that include original cost plus capitalized improvements (less depreciation). Depreciation represents a source of funds to repay the cost of an asset over the asset's economic life. As plant and equipment age and are depreciated, the railroad's investment base decreases. However, when these long-term assets require improvements the railroad is also increasing its investment base through its expenditures on maintenance. Thus, depreciation approximates the asset's decreasing economic value, while the maintenance expenditures represent the renewing of the asset. Conceptually then, if plant and equipment are well maintained, capitalized maintenance and depreciation can theoretically offset one another. Notice at 9-10.

In continuing to think about this issue, we have grown more convinced that betterment accounting may underestimate—not overestimate—the value of the investment base. Track structure is valued at the original cost of the track at the time the original investment was made, plus betterments (valued at their original cost). Under depreciation accounting, track structure would be continually revalued. Due to inflation, track structure would, therefore, likely be valued at a higher level under depreciation accounting because its value is set at a later date.

Betterment accounting may also present an inaccurate picture of railroad profits. Since all maintenance other than betterments is considered to be an expense, a railroad's profits are understated in periods of high maintenance. Conversely, in periods of low maintenance, profits

[8] In the notice, we inadvertently referred to classes 1 and 2 as those describing abandonable lines. Categories 1 and 3 are actually the correct references for this purpose.

[9] Charles W. Hoppe, "The Extent of Excess Capacity," V.S. No. 3, Comments of the AAR, at 7-8.

will be overstated, since the railroads will not be showing an expense to reflect consumption of their assets. This contrasts with depreciation accounting which would require a depreciation expense every year. We do not know with exactness either the direction or the magnitude of these distoring effects of betterment accounting. We do believe, however, that the betterment accounting data are the best available at this time.

In valuing the asset base, we also must consider how to treat funds obtained through tax provisions such as accelerated depreciation and investment tax credits. In the past, we have deducted deferred taxes (which generally result from use of accelerated depreciation) from the net investment base. This policy was explained in Ex Parte No. 338, where we wrote:

> We are cognizant of the fact that this treatment confers a benefit on the carriers, in that they are receiving and retaining revenue which is not accounted as income. As indicated by some of the parties, the capital funds arising from deferred taxes have been contributed by the ratepayers rather than by investors in the company. Thus, it is appropriate to deduct the deferred tax account from the net investment rate base prior to any calculation of rate or return.

This issue has come before us many time subsequently. For example, we considered it—and reached a different conclusion—in Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide,* 364 I.C.C. 360. We believe, after weighing all the concerns expressed by parties on both sides of this issue, that deferred taxes should not be removed from the net investment base for ratemaking purposes.

In our notice of proposed guidelines in Ex Parte No. 347 (Sub-No. 1), we said:

> The deferred tax account can be considered a source of funds freed up for reinvestment. These funds constitute a substantial part—up to 20 percent in some cases—of the total capital available to individual railroads for this purpose. To the extent that the railroads are not allowed to earn a return on investments made with these funds, the incentive to undertake railroad investments with such funds is substantially reduced. Instead, an environment is created in which there is an incentive to take funds generated within the railroad industry and invest them elsewhere, where market-determined rates of return are available. We are concerned that this may thwart the intent of Congress in passing the Revenue Acts of 1954 and 1962, to provide business enterprise with tax benefits as a means of spurring capital spending.

While we are not considering ratemaking per se here, the economic principle is the same. If we exclude internally generated funds, whether stemming from accelerated depreciation or any other railroad activity, from the investment base, the effect will be to establish a rate of return below the cost of capital. This, in turn, will result in incentives to railroads to invest these funds in nonrail operations. In short, we are con-

cerned that exclusion of the deferred tax account from the investment base would conflict with our duty under section 10704(a)(2)(A) of the Interstate Commerce Act as amended by the Rail Act to set revenue adequacy figures at levels that would "provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation."

We have carefully considered the argument presented in the verified statement of George H. Borts on behalf of the Western Coal Traffic League that special tax provisions should be excluded from the investment base since in a competitive industry competition will force the firm to pass the tax savings on to consumers in the form of lower prices. We reject this argument for two reasons. First, we again point out that we are not guaranteeing any railroad any rate of return. If competition generally has the effect postulated by Mr. Borts, then it will also have this effect on railroads. Second, we find the reasoning to be in error in two respects. The first is that tax (or other savings) will not be passed through to consumers if railroads are not covering economic costs, including the costs of capital. Railroads will either use these savings to help recover economic costs or will leave the market if they believe recovery is not likely. Our second concern with this reasoning is that while it is correct that if funds provided through tax benefits are restricted to use in a particular industry, then the additional investment may somewhat lower prices charged by that industry; however, as we explained above, the railroad industry must compete with all other industries for investment funds. The cost of capital reflects the minimum required rate of return expected by investors if they are to provide funds *after* all tax (and other) provisions are considered. That is, the cost of capital reflects the actual competitive return. We thus, reject this argument and conclude that the investment base should not be adjusted to reflect special tax provisions such as accelerated depreciation and investment tax credits.

Cost of Capital Determination

For this initial revenue adequacy determination, which uses an original cost method of asset valuation, the proper cost of capital is the nominal cost. The nominal cost of capital is the cost of capital stated in the usual way in terms of current dollars. The nominal cost of capital is the sum of the real cost of capital and the expected rate of inflation. The conclusion is widely accepted that the nominal cost of capital must be applied to an original cost-based asset valuation if the railroads are to be compensated for inflation.

In previous revenue adequacy proceedings, we calculated the nominal cost of capital by taking a weighted average of the cost of equity capital

and the embedded cost of debt capital. The weighting was based on the capital structure of the railroads using embedded debt levels. We concluded in those proceedings that the rail industry's total capitalization could be fairly characterized as 40-percent debt and 60-percent equity. In the notice we asked for comments on whether these figures should be changed. We anticipated that we might receive comments indicating a perceived change in the industry's capital structure ratio. The railroads, however, made a strong argument that this ratio should be calculated using current debt rates and equity values. If this is done, they argue, the correct debt-equity ratio is not 40:60, but 23:77.

For purposes of this initial revenue adequacy determination, however, we will continue to use a 40:60 ratio. This is primarily because we are concerned that a change of the type suggested by the railroads was not anticipated in our notice, and not, therefore addressed by other parties. We believe before such a change is made further comment would be proper. We thus defer consideration of this method to a later proceeding.

In the notice, we also proposed to change the way we determine the current nominal cost of capital. Previously, we had based this rate on the cost of embedded debt and the market value of equity. We said in the notice, however, that we now believe that for a revenue adequacy determination the current cost of debt should be used. We reached this conclusion after considering what concepts a revenue adequate determination is designed to reflect. We noted that:

> Adequate revenues should assure retention and attraction of capital to provide a sound transportation system. A sound transportation system should return the cost of capital to investors and reflect that cost of capital in prices paid by users. These are forward-looking concepts. The year and the rate at which past debt was raised are not relevant for these purposes. The more relevant consideration is the cost to the railroad of raising (or not losing) capital for current and future investment. In periods of high and unpredictable rates of inflation, the use of embedded debt rates underestimates the cost of capital. Conversely, in periods when inflation fell below current levels, the embedded debt rate might over-estimate the cost of capital. If a railroad attempts to raise capital today, while maintaining its current capitalization structure, its cost of capital is the weighted average of the current cost of debt and the market value of equity. If the flexibility granted revenue inadequate carriers is restricted in periods of high debt rates to carriers earning less than the cost of capital calculated using the embedded debt rate, some economically efficient investments (those earning at least the current cost of capital) may be foregone. The use of the current cost of debt gives carriers the opportunity to make such efficient investments. We believe that this forward-looking approach is contemplated by the Rail Act.

Many comments argued that our proposed use of current debt rates instead of embedded debt rates is incorrect since holders of debt receive a return at the rate provided by the debt agreement regardless of what subsequent changes might occur in the cost of debt. While it is correct that

holders of debt are paid at embedded rate levels, we do not believe this is relevant. As we have noted repeatedly in this decision a revenue adequacy standard must provide railroads with the opportunity to compete for scarce investment funds. This means that railroads must be provided with the opportunity to earn a rate of return equal to the cost of capital. The current cost of capital is equal to the weighted average of the current rates of debt and equity.

Though only indirectly related to this proceeding, it is still interesting to contemplate what might happen in future rate cases if the embeeded debt rate argued for by many heavy users of rail service were adopted. In a rate case that came up in 1981, it is reasonable to assume that the rate would be premised on covering the cost of old debt—which was purchased at comparatively low prices. This would be to the advantage of rail shippers whose rates would reflect debt costs to the railroad well below the current market price. Let us assume further, however, that the railroads are today issuing debt instruments at much higher rates. Five years from today, rates will be premised on coverage of such debt instruments, even though debt might then be available at far lower rates. Shippers dependent on rail service would then be forced to pay rates at levels higher than would be necessary if current debt costs were used.

The same principle applies to a revenue adequacy determination. The use of embedded debt rates in calculating the cost of capital does not result in the minimum return necessary to attract capital to the railroad industry. In some years the calculated cost of capital would be too low; in others it would be too high.

For all of these reasons, we conclude that for purpose of revenue adequacy determination, we will use the current cost of debt in calculating the cost of capital.

Financial Ratios Indicative of a Carriers Financial Condition

In the notice, we observed that:

> While a financially sound firm must earn at a minimum a rate of return at least equal to the cost of capital, evidence that a carrier is earning an adequate rate of return is not sufficient to determine if it is earning adequate revenues. It is possible for a firm to earn the cost of capital over a short period, even though it is not financially sound. For example, a carrier may not have sufficient liquidity to meet financial obligations that are soon to come due. In recognition of this, we proposed to make a determination of sound financial condition an additional necessary condition for revenue adequacy. Notice at 16.

We further proposed to base this determination on specific financial ratios. Specifically, as additional necessary standards for a finding of revenue adequacy, we proposed an operating ratio of 0.85 or less, a fixed

charge coverage ratio of 3.5 or greater, and a throwoff to debt ratio of 3.5 or greater. We stated that the operating ratio (operating expenses as a percentage of operating revenue) would show whether a carrier's operations were covering its current expenses, while the fixed charge coverage ratio (income before fixed charges as a percentage of fixed charges) and the throwoff-to-debt ratio (cash flow as a percentage of long-term debt due within 1 year) would give indications of a firm's ability to meet its existing financial obligations. We asked for comments on whether the use of these ratios is appropriate, whether the figures proposed are the most suitable, and whether these three financial ratios are the best ones to show the soundness of a carrier's financial condition.

After considering these comments we now believe that using these financial ratios as conditions to a finding of revenue adequacy would be misleading. Financial ratios are intended to provide summary information that, if not interpreted within the proper context, could suggest incorrect conclusions. For example, a firm's fixed charge ratio might be low because of its ability to riase long-term debt. That ability could, in turn, be a reflection of its strong financial outlook. Yet the low fixed charge ratio would lead us to conclude the carrier was revenue inadequate. Because of the possible ambiguity, we have decided that these financial ratios should not be used in revenue adequacy determinations. We believe firmly that the rate of return standard is correct, and will base our determinations on it.

Interpretation of the Number of Carriers Found Revenue Adequate

Some participants in this proceeding have presented data showing that under the standards proposed in the notice only a small number of railroads will be found to have adequate revenues. The argument being made is that this finding indicates that the standard proposed in the notice is not valid. We believe the opposite is true. Sections 2(6) and 2(7) of the Rail Act explicitly found that the railroad industry's earnings are insufficient to generate funds for necessary capital improvements and that by 1985 there will be a capital shortfall within the industry of between $16 billion and $20 billion. These findings make clear that Congress did not anticipate that a large number of carriers would be found to have adequate revenues.

We recognize that the increase in revenue needed for findings of revenue adequacy may be large. We do not believe this indicates a problem with the standard. For example, in his verified statement, Donald V. Kane concluded that:

> [I]n *1978 and 1979*, the estimated *increase in revenue requirements* for class I railroads as a whole, in order for those railroads to be determined revenue adequate under the I.C.C.'s "replacement cost" methodology is *not less than $8 billion per year*, i.e., an increase of approximately 33 percent.[10]

We note that this estimate may be inflated depending on how nonused and useful plant was eliminated from the base, and that, even with this possible problem, the estimate is not out of line with the estimate in the Rail Act.

Several parties have compared our individual railroad determinations in Ex Parte No. 353 with their estimate of individual railroad determinations using a rate of return standard. That the number of revenue adequate railroads differs under the two standards is not surprising. The two standards were designed to measure different concepts. We do not believe this indicates a problem with the rate of return-cost of capital standard.

THE USE OF REPLACEMENT COST ASSET VALUATION FOR FUTURE DETERMINATION

In the notice, we said that we were considering using a replacement cost methodology in valuing assets in future revenue adequacy determinations. Under the replacement cost valuation method we proposed, the investment base would be the sum of: (1) all investment that is used and useful (valued at its depreciated replacement cost); (2) all investment necessitated by regulation (value at its depreciated replacement cost); and (3) investment that is abandonable under current rules (valued at its net liquidation value). Since this calculation would already account for inflation, we noted that the current, real (as opposed to nominal) cost of capital would be the proper standard to use with a replacement cost valuation in order to make a revenue adequacy determination.

We continue to believe that replacement cost valuation can be preferable to original cost valuation. While the methods produce equal discounted cash flows, the regular and continuing calculation of depreciation charges and inflation adjustments under the replacement cost method may better reflect the true economic costs associated with an investment. Further, the replacement cost method is preferable becaue it comes closer to the competitive result. That is, at any point in time, the revenue requirement implications of using replacement costs are closer to the return on investment that would be required by a competitive

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[10] Donald V. Kane, "Rates of Return and Revenue Requirements of Railroads under Ex Parte No. 393, January 23, 1981," appendix A, comments of the Edison Electric Institute, at p. 3. Emphasis in the original.

market. This occurs because the timing of inflation adjustments under the replacement cost method are more like those made by the market.

We recognized in our notice and acknowledge again here that the replacement cost method has data requirements that are more difficult than those of the original cost method. The major difficulty with using the replacement cost method is the estimation of the actual value of individual investments. Since this valuation is not based on actual transactions, the value of particular investments may be difficult to estimate. We are currently contemplating the initiation of a proceeding that will consider rules requiring railroads to file replacement cost data with the Commission. This method, if adopted, would be mechanized through the Commission's depreciation and life analysis systems. Using these systems, valuations based on depreciated replacement cost (original cost indexed to account for inflation), can be readily determined for all assets other than track. The track structure can be included by pricing it at current cost and depreciating such cost in a manner consistent with maintenance standards. Because the adoption of such a system would greatly lessen the problems of replacement cost valuation, we are deferring adopting a replacement cost method for future revenue adequacy determinations until that proceeding is begun, comments reviewed, and the issued raised decided.

An additional problem with the replacement cost method is that it requires use of the current, real cost of capital as the rate of return standard. The real cost of capital cannot be observed directly, but we believe that the real cost of capital can be calculated by subtracting some generally accepted estimate of inflation expected over the revenue adequacy determination period from our estimate of the nominal cost of capital. Such an estimate of the expected inflation rate might come from estimates already made by the Council of Economic Advisors or the Federal Reserve Board. Since we do not need to resolve this question in making our initial determination and have deferred the entire question of the replacement cost methodology, we are deferring further consideration of calculating the real cost of capital, as well.

We said in the notice that we expect that identification of which lines are used and useful and which are abandonable would be one of the most difficult elements of using the replacement cost method. We believe the best method of identifying such lines is to consider those in categories 1 and 3 of a railroad's system diagram map as abandonable under current rules. Category 1 lines are those the railroad will seek to abandon within 3 years. Category 3 lines are those for which the Commission is already considering an application for abandonment.

We recognize that, as argued by the railroads, a system diagram map identifies only those lines that have been or may be proposed for abandonment. While we understand that some lines proposed for abandonment may ultimately not be abandoned, we believe the system diagram maps provide the best available information on what is not used and useful. It is, after all, the railroad's evaluation of a line's prospects that placed it in either category 1 and 3. Further, as noted by Mr. Hoppe, those railroads that are most likely to be found revenue adequate generally have the least number of lines in categories 1 and 3. Thus, we would not expect this method of identifying abandonable lines to lead us to incorrect findings of revenue adequacy if and when the replacement cost method is adopted. We also do not expect that railroads will keep abandonable lines out of categories 1 and 3. Railroads have strong incentives to identify all abandonable lines since they are often costly to maintain, and under our present opportunity cost rules they may abandon lines that produce more revenue through liquidation than through continued operation.

While we perceive some difficulties in implementing a replacement cost valuation method, we believe that it is conceptually the best method available. We thus hope to adopt the replacement cost method for future revenue adequacy determinations, and will do so then based on this record. Decisions on the use of an accounting system that adjusts asset values and the calculation of a real cost of capital are deferred.

In the notice, we stated that we would consider conducting a proceeding using the replacement cost method if an affected party believed that the original cost method had not fairly indicated a railroad's revenue adequacy. In view of our deferral of a decision on replacement cost methodology, we will not entertain such petitions concerning the revenue adequacy determinations that we are making in this decision.

REVENUE ADEQUACY DETERMINATIONS

Based on the standards described above, we have made revenue adequacy determinations for 35 class I railroads. Data for 1979 are the most recent for individual railroads that are available for analysis. In Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 I.C.C. 344 (1979), we estimated that the cost of capital using the embedded debt rate was 11.0 percent. For this proceeding, we reestimated the cost of capital using the current cost of debt (and a 40:60 debt-equity ratio)

and have found it to be 11.7 percent.[11] Using the cost-of-capital standard for revenue adequacy, a railroad will be found adequate if it has a 1979 return on investment of 11.7 percent or higher.[12] Railroads with lower returns will be considered revenue inadequate.

After analyzing the data for the 35 class I railroads, we have found that only 3 earned adequate revenues in this most recent period. These railroads are the Bessemer & Lake Erie, Elgin, Joliet & Eastern, and Fort Worth & Denver.[13] Their rates of return were 11.7, 13.2 and 22.8 percent respectively. A summary of our finding for each railroad is contained in the appendix.

We find:

1. The current standards for revenue adequacy, found at 49 CFR 1109.25, are inappropriate for the purpose of the Rail Act and are repealed.

2. The standard for revenue adequacy shall be rate of return equal to the current cost of capital.

3. To assess the value of a railroad's rate base for the initial determination of revenue adequacy, we shall use the sum of the original cost of track assets, plus betterments to track, and the depreciated book value of all other assets. The investment base shall not be adjusted to reflect special tax provisions such as accelerated depreciation and investment tax credits. The cost of capital will be calculated using the current cost of debt and equity, and a debt-equity ratio of 40:60.

4. Under these standards, the following 3 of the 35 class I railroads are revenue adequate: Bessemer & Lake Erie; Elgin, Joliet & Eastern; and Fort Worth & Denver.

[11] In Ex Parte No. 363, *Adequacy of Railroad Revenue (1979 Determination)*, 362 I.C.C. 344 (1979), the Commission found the current cost of debt to be 9.0 percent and the cost of equity capital to be 13.5 percent. Using these values, the composite cost of capital in this proceeding was computed as follows:

$$\begin{array}{rr} 9.0 \times 0.40 = & 3.6 \\ 13.5 \times 0.60 = & 8.1 \\ \hline & 11.7 \end{array}$$

[12] Return on investment is computed by dividing net railway operating income (Annual Report Form R-1 Line 67, column (b)) by a calculated investment base. This base equals net investment in road and equipment (R-1, schedule 352 A, line 39, column d-column e) plus working capital from Rail Form A, minus interest during construction (R-1, schedule 352 B, line 43 columns b + c + d + e), minus other elements of investment (if debit), (R-1 schedule 352 B, line 47, columns b + c + d + e). The denominator is the average of beginning and end of year data.

[13] The FW&D is a wholly owned subsidiary of Burlington Northern Railroad. It may be, therefore, that it is misleading to consider it separately from its parent railroad, since we have very little information on financial transactions between the parent and the subsidiary. This entire question will be dealt with in a future proceeding.

5. This proceeding will not significantly affect either the quality of the environment or conservation of energy resources; nor will it have adverse economic effects on small businesses or other entities.

In this proceeding we have used 1979 data in order to meet the statutory deadline set by section 205(b) of the Rail Act. In the future, we will make every effort to guarantee that our annual revenue adequacy determinations are made as quickly as possible after data for the prior year become available. Since 1980 data will be available shortly, we will make our next revenue adequacy determination no later than September 15 of this year. Future annual revenue adequacy determinations will use the same time frame. This will minimize regulatory lag and improve the reliability of our calculations.

COMMISSIONER CLAPP, concurring in part and dissenting in part:

Occasionally, the Commission is called upon to make a decision which observers may view as a bellweather of regulatory philosphy. While some have tried to characterize this proceeding in this light, it would be a mistake to interpret it as such. Our task here is straight forward, although the solution is complex and elusive. We must ascertain theoretically and practically sound standards for measuring a railroad's relative financial condition. We cannot set standards based on a belief that we should find a certain number of carriers revenue adequate or inadequate—our standards must rest on their own inherent financial integrity.

It is also important to realize that the direct impact of the annual revenue adequacy determinations will not be great until October 1984. Currently, as a result of the Rail Act, a carrier deemed revenue adequate cannot impose a surcharge on its share of joint rates unless it applies to a line which carries at least 1 million gross ton-miles of traffic per mile per year. All carriers are assured that no rate can be found unnecessarily high if there is effective competition. Absent a contractual agreement, no railroad can be required to maintain a rate which returns less than a statutorily defined "cost recovery percentage" (160 percent of variable costs at present; depending on rail profitability this will escalate to between 170 and 180 percent of variable costs by October 1984). Additionally, cost increases are automatically passed through under a statutory formula. The railroads are also provided an additional "zone of rate flexibility" of 6 percent of the inflation adjusted rate per year. A rate within this zone may not be suspended, but if it is challenged the Commission must take carrier revenue adequacy or inadequacy into consideration. The statute emphasizes the importance of this factor, but does not detail specific consequences. In substance, this emphasis reflects Commission policy over the last several years.

Beginning with October 1984, a finding of revenue adequacy will have a more direct impact. The guaranteed "zone of rate flexibility" will change to 4 percent per year, but carriers deemed revenue adequate cannot use it. This does not mean that carriers which are revenue adequate automatically would be denied additional rate flexibility needed for them to maintain that status, but the possibility of challenge would be present.

To date, the Commission has received no indication that the few carriers who arguably could be considered revenue adequate under some alternative approach have any substantial interest in filing surcharges on joint-line movements. Assuming this continues, it is doubtful that the revenue adequacy determinations will result in any adverse regulatory consequences before 1984. The Commission will, of course, continue to take the financial condition of the railroads into account in exercising its responsibilities under the law. A financially sound railroad system is of essential importance to America's future transportation needs. The Rail Act has eliminated the uncertainty that some carriers felt in the past if they wanted to experiment with innovative pricing. We have encouraged such experimentation. This is a necessary and positive step toward railroad revitalization.

There is not a member of this Commission who doubts that it is important—indeed crucial—that the railroad industry be healthy and on a sound fiscal footing. We share—and are implementing—the resolve of the Congress that artifical restrictions which prevent the railroads from reaching that objective be removed. Concern regarding the efficacy of the particular test chosen for the determination of financial adequacy in no way reflects hesitation in the commitment to pursue that goal. That should be clearly understood. Nor, alas, does it signify that a perfect substitute is readily at hand. It isn't.

In this context, I am in substantial agreement with Commissioner Gilliam's observations. In theory, ROI is a sound indicator of many of the revenue adequacy criteria named by the statute. As used in this decision, however, there are certain technical deficiencies which limit its reliability in some situations. While the majority has acknowledged some of these deficiencies, others remain. For example, net railway operating income (NROI), the numerator of ROI, is calculated by subtracting all income tax expense from net revenue from railway operations. In some cases, the tax figure includes taxes attributable to nonrailroad related activities. If, as I believe we are required to, we are looking at railroad related activities, this will result in an inaccurate picture. Further, NROI, as presently computed, does not reflect certain rail-related income. The principal income sources are below-the-line items such as dividend

income and undistributed income from subsidiaries' rail activities (clearly, nonrail activities should not influence the results here), and interest income on railroad working capital investment.

One problem with trying to recompute ROI figures to take these matters into account is the fact that the income statement format presently used for reporting purposes does not permit segregation of income or expense accounts between rail and nonrail activities. This is an area which needs to be addressed in the future if a single ROI standard is to be used. Until problems such as this and others mentioned in the report can be resolved, we should check the results of our ROI computations against other relevant financial ratios such as a firms's operating ratio, throwoff to debt and fixed charge coverage ratios, return on shareholders' equity, return on total capitalization, the dividend payout ratio, and the annual percentage increase in net transportation investment.

A careful analysis of such ratios together with reported financial statements can be a useful tool in revealing any unusual characteristics which reliance on the single ROI figure will not show. Analysis of the facts behind the figures is essential since the methodology used in computing the figures has significant imperfections. This type of analysis will call for the exercise of some judgment, but I have great confidence in the ability of this Commission to make those assessments in a manner that will fulfill the intent of Congress. Until the practical problems with ROI can be remedied, this appears to be the most promising approach.

As a practical matter, in most instances, it would appear that the majority's determination and this suggested approach would lead to similar, although perhaps not identical, results. A substantial majority of the Nation's railroads clearly are revenue inadequate, in varying degrees. There are only two or three railroads which are clearly revenue adequate under any test. Under the ROI test, there are perhaps a handful more that could best be described as only marginally inadequate. Those firms may shift between adequacy and inadequacy in different years. Since revenue adequacy is a long-term concept, it makes more sense to use a 3- or 4-year moving average standard instead of looking only at 1979 figures as the majority does.

The majority's treatment of class I affiliated railroads appears inconsistent. Why, for example, are the Chessie System, Family Lines, and Burlington Northern affiliates looked at individually, while the Southern Railway System is treated only in the aggregate? Whatever treatment is used in future proceedings should be applied uniformly—either make determinations for all class I railroads without regard to affiliates, or make one determination for all affiliated lines.

It is my hope and expectation that lenders and other financial analysts reading this report will recognize that no one measure presently available can, as a practical matter, fully measure railroad revenue adequacy. Railroads which presently enjoy favorable credit ratings should not be penalized by financial institutions merely because this decision labels some of them revenue inadequate. Proper financial evaluation for that purpose requires a more sophisticated approach than is used here. By 1984, when our findings take on greater significance, I believe that most if not all of the problems noted can and should be resolved.

COMMISSIONER GILLIAM concurring:

I agree with the majority that the return on investment (ROI) test is the most appropriate measure of railroad revenue adequacy. However, because of the present inaccuracies in the calculation of ROI, I would also use other financial ratios to make sure that our results are not distorted. While a single test is preferable in terms of simplicity, I am hesitant to rely solely on the use of one ratio until the application of ROI is further refined.

I concur in the result of this decision primarily because of the present limited application of our findings to the surcharge provision of the Rail Act. It is my hope that we will have eliminated the problems associated with the use of the ROI test prior to the time our findings have wider application.

It is ordered:

The regulations found at 49 CFR 1109.25 are repealed.

By the Commission, Acting Chairman Alexis, Commissioners Gresham, Clapp, Trantum, and Gilliam. Commissioner Gilliam concurred with a separate expression. Commissioner Clapp concurred in part and dissented in part with a separate expression.

AGATHA L. MERGENOVICH,
Secretary.

(SEAL)

Railroad revenue adequacy (1981 determination) (using ROI standard only) prepared by the Bureau of Accounts, Section of Financial Analysis

Carrier	1979	Determination of revenue adequacy
Eastern District	*Percent*	
Baltimore & Ohio	4.5	Inadequate
Bessemer & Lake Erie	11.7	Adequate
Boston & Maine	0	Inadequate
Chesapeake & Ohio	4.6	Do.
Conrail	0	Do.
Delaware & Hudson	0	Do.
Detroit, Tol. & Ironton	5.1	Do.
Elgin, Joliet & Eastern	13.3	Adequate
Grand Trunk Western	2.5	Inadequate
Norfolk & Western	8.9	Do.
Pitt & Lake Erie	10.1	Do.
Western Maryland	9.6	Do.
Southern District		
Clinchfield	11.6	Do.
Florida East Coast	1.5	Do.
Illinois Central Gulf	0	Do.
Louisville & Nashville	5.1	Do.
Seaboard Coast Line	7.2	Do.
Southern System	9.1	Do.
Western District		
ATCH, TOP, & Santa Fe	5.9	Do.
Burlington Northern	4.1	Do.
Chi & Northwestern	0	Do.
Chi, Milwaukee, SP & PAC	0	Do.
Colorado & Southern	0	Do.
Denver & Rio Grande W	8.6	Do.
Duluth, Mes & Iron RNG	6.1	Do.
Fort Worth & Denver	22.8	Adequate
Kansas City SO	6.6	Inadequate
Missouri-Kans-Tex	5.7	Do.
Missouri Pacific	8.4	Do.
St. Louis-San Francisco	5.8	Do.
St. Louis-Southwestern	7.5	Do.
Soo Line	8.2	Do.
Southern Pacific	1.6	Do.
Union Pacific	7.6	Do.
Western Pacific	4.4	Do.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492, 81-2633, 81-2634, 81-2635, 81-2636, 81-2637, 81-2638 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY,

Petitioner

Alabama Power Co., et al., Petitioners in No. 81-1493; Chemical Man. Assoc. Petitioner in No. 81-2634; Edison Electric Institution, Petitioner in No. 81-2635; American Paper Institute, Petitioner in No. 81-2636; Association of American Railroads, Petitioner in No. 81-2638; Iowa Electric Light & Power Co., et al., Petitioners in No. 81-2638; Western Coal Traffic League, Petitioner in No. 81-2859

v.

INTERSTATE COMMERCE COMMISSION AND UNITED STATES OF AMERICA,

Respondents

Association of American Railroads, et al., Intervenors in No. 81-1493; Western Coal Traffic League, et al., Intervenors in Nos. 81-2633/8; Carolina Power & Light Co., et al., Intervenors in No. 81-2859;
(ICC Ex Parte No. 393)

SUR PETITION FOR REHEARING

Present: GIBBONS, *Circuit Judge*, FISHER, *Chief Judge, District Court* and MEANOR, *District Judge*

The petition for rehearing filed by Nevada Power Company, Iowa Electric Light & Power Company, Iowa Power & Light Company, Oklahoma Gas & Electric Company, Southwestern Electric Power Company, Carolina Power & Light Company, South Carolina Electric & Gas Company, Virginia Electric and Power Company, Southern Electric System, Edison Electric Institute, Western Coal Traffic League, American Paper Institute, Inc. and The National Industrial Traffic League in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

/s/ ______________________________

JOHN J. GIBBONS
Circuit Judge

Dated: Nov 15 1982

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*Hon. Clarkson S. Fisher, Chief Judge, United States District Court for the District of New Jersey, sitting by designation.

*Hon. H. Curtis Meanor, District Judge for the District of New Jersey, sitting by New Jersey.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1492, 81-2633, 81-2634, 81-2635, 81-2636, 81-2637, 81-2638 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY,

Petitioner

Alabama Power Co., et al., Petitioners in No. 81-1493; Chemical Man. Assoc. Petitioner in No. 81-2634; Edison Electric Institution, Petitioner in No. 81-2635; American Paper Institute, Petitioner in No. 81-2636; Association of American Railroads, Petitioner in No. 81-2638; Iowa Electric Light & Power Co., et al., Petitioners in No. 81-2638; Western Coal Traffic League, Petitioner in No. 81-2859

v.

INTERSTATE COMMERCE COMMISSION AND UNITED STATES OF AMERICA,

Respondents

Association of American Railroads, et al., Intervenors in No. 81-1493; Western Coal Traffic League, et al., Intervenors in Nos. 81-2633/8; Carolina Power & Light Co., et al., Intervenors in No. 81-2859;
(ICC Ex Parte No. 393)

ON PETITION FOR REVIEW OF AN ORDER OF THE INTERSTATE COMMERCE COMMISSION*

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*[Abbreviated Caption]

Present: GIBBONS, *Circiut Judge*, FISHER,* *Chief Judge, District Court* and MEANOR,* *District Judge*

JUDGMENT

These causes came on to be heard on the record from the Interstate Commerce Commission and were argued by counsel on September 20, 1982.

On consideration whereof, it is now here ordered and adjudged by this Court that the said petition be, and the same is hereby denied and the decision of the said Commission, Ex Parte 393, 364 I.C.C. 803 (1981), dated March 26, 1981, and served March 30, 1981, be, and the same is hereby affirmed in all respects. Costs taxed against petitioners.

ATTEST:

/s/____________________

SALLY MRVOS
Clerk

October 19, 1982

Certified as a true copy and issued in lieu of a formal mandate on December 3, 1982.

/s/____________________

M. ELIZABETH FERGUSON
Chief Deputy Clerk, United States Court of Appeals for the Third Circuit

Costs taxed in favor of Association of American Railroads (Intervenor-Resp.) as follows:

Appendix	$348.33
Brief	568.40
TOTAL	$916.73

*Honorable Clarkson S. Fisher, Chief Judge, and Honorable H. Curtis Meanor, District Judge, United States District Court for the District of New Jersey, sitting by designation.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 81-1492, 81-2633/38 and 81-2859

BESSEMER AND LAKE ERIE RAILROAD COMPANY

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA

OPINION ON DENIAL OF MOTION FOR RECALL OF MANDATE

Submitted Under Third Circuit Rule 12(6)
January 25, 1983

Before: GIBBONS, *Circuit Judge*,
FISHER and MEANOR, *District Judges**

(Opinion Filed: January 26, 1983)

JOHN F. DONELAN, ESQ.
FREDERIC L. WOOD, ESQ.
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JOHN F. DONELAN, JR.
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*Hon. Clarkson S. Fisher, Chief Judge, and Hon. H. Curtis Meanor, District Judge, for the District of New Jersey, sitting by designation.

GIBBONS, *Circuit Judge*.

Certain petitioners in the above entitled case move to recall the mandate of this court and to schedule the case for reargument. Our judgment was entered on October 19, 1982, petitions for rehearing were denied by order dated November 2, 1982, and a certified judgment in lieu of mandate issued on December 3, 1982. The ground asserted in support of the motion is that by Section 103(b) of the Federal Courts Improvement Act of 1982, Public Law 97-164, 96 Stat. 25, April 2, 1982, 28 U.S.C. §46(b) was amended to provide:

> In each circuit the court may authorize the hearing and determination of cases and controversies by separate panels each consisting of at least three judges at least two of whom shall be judges of that court, unless such judges cannot sit because recused or disqualified, or unless the chief judge of that court certifies that there is an emergency including, but not limited to, the unavailability of a judge of the court because of illness.

The moving parties point out that in this instance the panel included two judges of the United States District Court for the District of New Jersey.

When the petitions were filed the Clerk of this Court, pursuant to the court's standard practice, circulated copies of the docket sheets to determine whether or not members of the court were recused pursuant to 28 U.S.C. §455. All active judges except Judge Gibbons indicated that they were disqualified. In addition, Senior Judges Van Dusen and Rosenn indicated disqualification. Senior Judge Albert B. Maris does not ordinarily sit in cases requiring oral argument. The court was aware of the provisions of Public Law 97-164, and of its effective date of October 1, 1982. Since, however, only one member of the court was eligible to hear the cases, on August 12, 1982 Chief Judge Seitz, pursuant to 28

U.S.C. §292(a), designated Chief Judge Clarkson S. Fisher and Judge H. Curtis Meanor to hear them. Orders containing those designations are on file in the Office of the Clerk of this Court.

The motion to recall the mandate and to schedule the cases for reargument will be denied.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit